MEMORANDUM

TO:       Stewart Guerin, Chair, Valuation of Securities (E) Task Force
         Members of the Valuation of Securities (E) Task Force

FROM:    Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC:      Charles Therriault, Director, NAIC Securities Valuation Office
         Eric Kolchinsky, Director, NAIC Structured Securities Group

DATE:    January 5, 2015


1. Background – During the NAIC 2014 Spring National Meeting, the Investment Analysis Office introduced an amendment to collect all text in the Purposes and Procedures Manual that referred or pertained to financial modeling or to the Structured Securities Group (SSG) in a new Part Seven. The proposed amendment included new text that referred to the newly formed SSG, but some of the text that was being consolidated into Part Seven referred to the SVO and reflected that it conducted the year financial modeling project prior to the formation of the SSG. Because the focus was on creating a new Part Seven, no effort was made to comprehensively modify references to the SVO or the SSG to more accurately refer to the staff that would perform the activity described in portions of the text. The Task Force adopted the proposal to create Part Seven of the Purposes and Procedures Manual on June 19, 2014. The amendment proposed in this memorandum would modify some references to the SVO and or SSG to more accurately identify which NAIC staff (SVO and SSG) are involved in the activity. The staff request that the proposal be received and released for a 45-day comment period.

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Section 1. The NAIC Structured Securities Group

The NAIC has determined that it is necessary to establish a Staff Function to provide NAIC members with an internal analytical capability to assess risks associated with insurer-owned securitizations and other complex financially engineered securities. The SSG is established as the Staff Function assigned to assess credit and other investment risks in securitizations and other complex financially engineered securities owned by state-regulated insurance companies.

Section 2. Definitions

The following terms used in this Part Seven have the meaning ascribed to them below.

**ABS** stands for asset-backed securities and means structured securities backed by consumer obligations originated in the United States.

**CMBS** stands for commercial mortgage-backed securities and means structured securities backed by commercial real estate mortgage loans originated in the United States. The definition of CMBS may refer to securitizations backed by commercial mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: 1) has the necessary information about the commercial mortgage and commercial mortgage loans originated outside of the United States to fully model the resulting securities; and 2) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

**Initial Information** means the documentation required to be filed with an Initial Filing of an RMBS or a CMBS CUSIP, pursuant to Section 6 below and pertaining to Loan Information, Reps and Warranty Information and Structure and Formation Information for the transaction, where:

- **Loan Information** means a review of the loan files by a third party to assess the sufficiency of legal title and other related issues;
- **Reps and Warranty Information** means the actual representation and warranties in effect for the securitization given by the mortgage originator(s) to the Trust pertaining to loan origination processes and standards, compliance with applicable law, loan documentation and the process governing put backs of defective mortgages back to the originator(s); and
- **Structure and Formation Information** means the waterfall, as described in the definition of Ongoing Information, information and documentation in the form of legal opinions and documentation governing the formation of the securitization and its entities relative to issues such as bankruptcy remoteness, true sale characterization, the legal standards and procedures governing the securitization and other similar issues.

**Legacy Security**, for the purposes of this [section] shall mean any RMBS and any CMBS that closed prior to Jan. 1, 2013.

**Ongoing Information** consists of: a) tranche level data; such as principal balance, factors, principal and interest due and paid, interest shortfalls, allocated realized losses, appraisal reductions and other similar information for the specific tranche; b) trust level data such as aggregate interest and principal and other payments received, balances and payments to non-trance accounts, aggregate pool performance data and other similar information; c) loan level performance information; and d) a computerized model of rules that govern the order and priority of the distribution of cash from the collateral pool (“i.e., the waterfall”) to the holders of the certificates/securities provided in the format and modeling package used by the NAIC financial modeling vendor.

**Original Source**, with respect to a specific set of data, means the Trustee, Servicer or similar entity that is contractually obligated under the agreement governing the RMBS or CMBS to generate and maintain the relevant
data and information in accordance with standards specified in applicable agreements or an authorized re-distributor of the same.

**Re-REMIC** is a securitization backed by (i) otherwise eligible RMBS from one or two transactions; or (ii) otherwise eligible CMBS from one or two transactions at closing. Re-REMICs cannot acquire any Underlying Securities after closing.

**RMBS** stands for *residential mortgage-backed securities* and means structured securities backed by non-agency residential mortgages originated in the United States, where the collateral consists of loans pertaining to non-multi-family homes. That includes prime, subprime and Alt-A mortgages, as well as home-equity loans, home-equity lines of credit and Re-REMICs of the above. Excluded from this definition is agency RMBS, where the mortgages are guaranteed by federal and federally sponsored agencies such as the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) or Federal Home Loan Mortgage Corporation (FHLMC) and loans against manufactured or mobile homes or collateralized debt obligations backed by RMBS. The exclusion covers bonds issued and guaranteed by, or only guaranteed by, the respective agency. Also not included are loans guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture’s Rural Development Housing and Community Facilities Programs. The definition of RMBS may refer to securitizations backed by residential mortgages, respectively, originated outside of the United States if and to the extent that the vendor selected by the NAIC to conduct the financial modeling: 1) has the necessary information about the residential mortgage and residential mortgage loans originated outside of the United States to fully model the resulting securities; and 2) can adapt the modeling process to account for any structural peculiarities associated with the jurisdiction in which the mortgage was originated.

**Underlying Security** means the RMBS or CMBS backing a Re-REMIC. A Re-REMIC cannot be an Underlying Security.

**NOTE:** The definitions of RMBS and CMBS reflect limitations associated with the financial modeling process, NAIC credit rating provider (CRP) internal naming conventions and SSG SVO processes, as more fully discussed below and may, therefore, be subject to a narrower or a broader reading in any reporting period. Please call the SSG SVO with any concerns or questions about the scope of the definitions for a given reporting period.

- It is possible that the scope of the RMBS and CMBS definitions may be broadened because the financial modeling vendors indicate other collateral or waterfall structures can be modeled.
- NAIC CRPs may adopt different internal conventions with respect to what market or asset segments are within their rated populations of RMBS, CMBS or ABS. This could affect the application of the adopted NAIC methodology or require the NAIC to select which naming process it wishes to adopt.
- It is possible that the SSG SVO will acquire analytical assessment capabilities that permit the assessment of existing, additional or different structured securities that cannot now be modeled or that are not currently rated.

**Price Grids** means and refers to CUSIP-CUSIP-specific price matrices containing six price breakpoints; i.e., each price corresponding to a specific NAIC Designation category. Each breakpoint on a Price Grid is the price point that tips the NAIC Designation for the RMBS CUSIP into the next NAIC Designation (credit quality/credit risk) category. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.
Official Price Grids means and refers to those generated by the SSG and provided to an insurance company or insurance companies that own the security for regulatory reporting purposes.

Section 3. Policies Defining the NAIC Structured Securities Group

a) Directive to Conduct Ongoing Operations

The SSG shall conduct the following ongoing operations:

(i) Develop and maintain expertise related to securitizations, including, but not limited to, knowledge of: market developments; issues and concerns related to applicable law; accounting regimes; structures including waterfall arrangements, governing the cash flows and performance characteristics of different types of collateral; and the financial modeling and other technology relevant to assessing their valuation and risk assessment;

(ii) Collaboration with the SVO to assess credit and other risks in non-securitizations, including for the purpose of assigning NAIC Designations;

(iii) Collaboration with other NAIC functions to facilitate related regulatory objectives;

(iv) Such other analytical assignments assigned or requested by the VOSTF or other NAIC regulator group;

pursuant to and in accordance with, the directives, procedures and instructions described in this Part Seven and those generally applicable to the SVO or other functions in this Manual and other applicable NAIC guidance.

b) SSG Regulatory Products

(i) NAIC Designations

The SSG is authorized to assign NAIC Designations.

(ii) NAIC 5*/6* Designations

The SSG is authorized to assign NAIC 5*/6* Designations to RMBS and CMBS under the Special Reporting Instruction contained in Part Two, Section 5 of this Manual as part of the administration of the annual surveillance discussed in Section 6 (a) of this Part and as may be subsequently authorized.

(iii) Price Grids

The SSG shall generate Price Grids as required for the annual surveillance specified below in Section 6 (a) of this Part; in the exercise of its responsibilities under the Regulatory Treatment Analysis Service (RTAS) as specified in Section 6 (c) below, or as shall otherwise be necessary in fulfillment of an assigned responsibility.

c) Other Applicable Policies – Application of Analytical Instructions; Responsibility for Investment Risk Analysis in New Financial Products; Process for Placing Securities Under Regulatory Review

The policies and instructions specified in Part One, Section 2 (d), 2 (e) and 2 (f) of this Manual made applicable to the SVO shall be also fully applicable to the SSG, allowing for differences inherent in structured securities, analytical assignment given to the SSG and methodologies to be applied by it.

Section 4. Administrative and Operational Matters
a) Certain Administrative Symbols

The following administrative symbols are used in the Valuation of Securities (VOS) Products to identify RMBS and CMBS that the NAIC vendor has confirmed will be subject to the financial modeling methodology described in Section 6 (a) of this Part.

- **FMR** indicates that the specific CUSIP identifies an RMBS that is subject to the financial modeling methodology.
- **FMC** indicates that the specific CUSIP identifies a CMBS that is subject to the financial modeling methodology.

The use of these administrative symbols in the VOS Products means the insurer should not use the filing exempt process specified in Part Two, Section 4 (d) of this Manual for the security so identified.

**NOTE:** The administrative symbols **FMR** and **FMC** are related to symbols that insurers are required to use in the financial statement reporting process. Under applicable financial statement reporting rules, an insurer uses the symbol:

- **FM** – as a suffix to identify modeled RMBS and CMBS CUSIPs;
- **AM** – as a suffix to identify CUSIPs not modeled and not designated by the SVOSSG but for which CRP ratings were used to derive the NAIC Designation.

The symbols FM and AM are inserted by the insurer in the financial statement as a suffix in front of the NAIC Designation category—i.e., 2FM.

b) Quarterly Reporting of RMBS and CMBS

To determine the NAIC Designation to be used for quarterly financial statement reporting for an RMBS or CMBS purchased subsequent to the annual surveillance described in Section 6 (a) of this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) and follows the instructions in Section 6 (a) (iii) (3) (a) (v) of this Part Seven below or follows the instructions in Section 6 (a) (iv) of this Part Seven below, subject to, and in accordance with, SSAP No. 43R.

c) Filing Exemptions

(i) Limited Filing Exemption for RMBS and CMBS

- **(A) RMBS and CMBS that can be Financially Modeled.**
  
  RMBS and CMBS that can be financially modeled are exempt from filing with the SVO.

  NAIC Designations for RMBS and CMBS that can be financially modeled are determined by application of the methodology discussed in Section 6 (a) (iii) of this Part Seven, not by the use of credit ratings of CRPs.

- **(B) RMBS and CMBS securities that cannot be Financially Modeled**
  
  (1) But are rated by a CRP
  
  RMBS and CMBS that cannot be financially modeled but that are rated by a CRP are exempt from filing with the SVOSSG. The NAIC Designations for these RMBS and CMBS are determined by application of the modified filing exemption discussed in Section 6 (c) (iv) (A) of this Part Seven.
(2) But are not rated by an CRP
RMBS and CMBS that cannot be financially modeled and that are not rated by a CRP are not filing exempt and must be filed with the SVOSSG as discussed below in Section 6 (a) (iv) (B) of this Part Seven. See also, Part Two, Section 5 (i) of this Manual.

(ii) Filing Exemption for ABS
ABS rated by a CRP are exempt from filing with the SSG pursuant to the filing exemption contained in Part Two, Section 4(d) of this Manual.

d) Review of Decisions of the SSG
Analytical decisions made through the application of financial modeling are not subject to the appeal process specified in Part One, Section 2 (g) of this Manual. In the absence of an appeal, the SSG shall provide whatever clarification as to the results of financial modeling is possible to any insurer who requests it and owns the security, provided that it is not unduly burdensome for the SSG to do so. Any decision made by the SSG that results in the assignment of an NAIC Designation and does not involve financial modeling methodology, whether developed by the SSG on its own or in collaboration with the SVO, is subject to the appeal process in Part One, Section 2 (g) of this Manual.

Section 5. Required Data and Documents for Transactions Submitted to the SSG

a) General Policy on Required Data and Documentation
The policy statement set forth in this Section 5 (a) shall be applicable generally to any transaction filed with the SSG for an analytical assessment, including, but not limited to, a Price Grid or for assignment of an NAIC. Any filing with the SSG is deemed to be incomplete unless the insurer has provided the information, documentation, and data in quantity and quality sufficient to permit the SSG to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine the requested analytical value. It is the obligation of the reporting insurance company to provide the SSG with all necessary information. It is the responsibility of the SSG to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

b) Documentation Standards and Procedure for Annual Surveillance of RMBS and CMBS
(i) Documentation Standard
In order for an insurer-owned RMBS or CMBS to be eligible for the year-end modeling process, conducted pursuant to this Part Seven, Section 6 (a) below, the analysis must be based on information, documentation and data of the utmost integrity.

A Legacy Security must meet the Ongoing Information requirements.

An RMBS, CMBS or Re-REMIC that is not a Legacy Security must meet the Initial Information and Ongoing Information requirements. For the purposes of determining a Re-REMIC’s status as a Legacy Security, the closing date of the Re-REMIC (not the Underlying Security) shall be used.

The SSG may, in its sole discretion, determine that the Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling. If the SSG determines that the
Initial Information and/or Ongoing Information is not sufficient and/or not reliable to permit the RMBS or CMBS CUSIP to be eligible for financial modeling, it will communicate this decision to the insurer and invite a dialogue to ascertain whether alternative information is available that would be deemed sufficient and/or reliable by the SSG.

(ii) Initial Information Requirements
An RMBS or CMBS meets the Initial Information Requirements if the security meets one of the following three conditions:

1. **RTAS.** The RMBS or CMBS was assigned a preliminary price grid or designation as described in this Part Seven;

2. **Initial Sufficiency Filing.** The RMBS or CMBS was reviewed by SSG through an Initial Sufficiency Filing; or

3. **Safe Harbor.** The RMBS or CMBS meets the Safe Harbor requirements

A **Initial Sufficiency Information Filing**
An insurance company may file Initial Sufficiency Information with the SSG for the purpose of obtaining a determination that an RMBS or CMBS CUSIP is eligible for financial modeling under the annual surveillance process discussed in Section 8(iii) below.

Initial Sufficiency Information is only filed once for any given RMBS or CMBS. Reporting insurance companies are solely responsible for providing the SSG with Initial Information.

A determination by the SSG that a given RMBS or CMBS CUSIP is eligible for financial modeling after an Initial Sufficiency Filing assessment is subject to the further and continuing obligation that the SSG obtain or the insurer provide the SSG with updated Ongoing Information close to the date of the annual surveillance.

**Required Documents for Initial Sufficiency Filing** – An insurer that owns an RMBS or a CMBS for which Initial Information is not publicly available shall provide the SSG with the following documentation.

1. **RMBS**
   Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for an RMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:
   - Pooling and Servicing Agreement or similar
   - Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   - If applicable, ISDA Schedules and Confirmations or similar
   - Legal opinions given in connection with the transaction
   - Any other documents referenced by the above
   - Third-Party Due diligence scope document and raw results.– If less than 100% due diligence, detailed description of the loan selection process.
   - If applicable, loan purchase agreements or similar.
   - Loan Tape
2. **CMBS**

   Unless otherwise specified by the SSG in a Modeling Alert, as further described below, an Initial Filing for a CMBS consists of submission of Initial Information and Ongoing Information in the form of the following documentation:

   Pooling and Servicing Agreement or similar
   Prospectus, Offering Memorandum or similar; Accountant’s comfort letter
   If applicable, ISDA Schedules and Confirmations or similar
   Legal opinion given in connection with the transaction
   Any other documents reference in the above

   Asset Summaries
   Loan Tape

   Loan documents- including reliable information about the terms of the transaction; including, but not limited to, financial covenants, events of default, legal remedies and other information about financial, contractual or legal aspects of the transaction in form and substance consistent with industry best practices for CMBS issuance.

   In certain cases, additional documents below will enable the SSG to verify and validate initial underwriting information of the property securing the CMBS. These documents may be required in form and substance consistent with best practices for typical CMBS issuance.

   Historical operating statements and borrower’s budget
   Underwriter’s analysis of stabilized cash flow with footnotes of assumptions used
   Property type specific, rent roll information
   Appraisals and other data from recognized industry market sources
   Independent engineering report (Property Condition Assessment)
   Environmental Site Assessment (ESA) – Phase I/Phase II
   Documentation related to seismic, flood and windstorm risks
   Franchise agreements and ground leases, if applicable
   Management agreements.

3. **SSG Modeling Alerts**

   The SSG shall at all times have discretion to determine that differences in the structure, governing law, waterfall structure or any other aspect of a securitization or a class of securitization requires that insurance companies provide Initial Information and or Ongoing Information additional to or different from that identified in this Part Seven. The SSG shall communicate such additional or different documentation requirements to insurers by publishing a Modeling Alert on the NAIC website and scheduling a meeting of the Valuation of Securities (E) Task Force to ensure public dissemination of the decision.

B. **Safe Harbor**

   Safe Harbor options serve as proxies for the Initial Sufficiency filing.- The options reflect publicly available information that a third party has analyzed the Initial Information.- Because the structured securities market is quite dynamic, the list of Safe Harbor options may change frequently, with notice and opportunity for comment, as described in Part One, Section 6 of this Manual. An RMBS or CMBS meets the Initial Information requirement if:
i. At least two Section 17(g)-7 reports issued by different CRPs are publicly available; or

ii. A security that is publicly registered under the 1933 Federal Securities Act of 1933.

(iii) Ongoing Information Requirements
An RMBS or CMBS meets the Ongoing Information Requirements if Ongoing Information is available to the SSG and the relevant third-party vendor from an Original Source. The SSG, in its sole discretion and in consultation with the relevant third-party vendor, may determine that the Ongoing Information is not sufficient or reliable to permit a given RMBS or CMBS CUSIP to be financially modeled. However, in making such a determination, the SSG shall take into account reasonable market practices and standards.

(iv) Special Rules for Certain Re-REMICs
Re-REMICs are generally simple restructurings of RMBS or CMBS. An Initial Sufficiency Filing for a Re-REMIC (a) which is not a Legacy Security itself but (b) where each Underlying Security is a Legacy Security shall not require submission of information regarding the Underlying Securities. In most cases, a prospectus for the Re-REMIC will be sufficient. If the SSG determines that additional information about the Re-REMIC structure or formation is required, it will communicate this decision to the insurer and invite a dialogue to ascertain whether additional information is available that would be deemed sufficient by the SSG.

Section 6 Analytical Assignments

a) Annual Surveillance of RMBS and CMBS – Modeled and Non-Modeled Securities - General Instructions

(i) Scope
This Section 6 (a) explains the financial modeling methodology applicable to RMBS and CMBS (defined in Section 2 of this Part above) securitizations and the carrying value methodology applicable to modeled and non-modeled securities subject to Statement of Statutory Accounting Principles No. 43 Revised – Loan-Backed and Structured Securities (SSAP No. 43R). Please refer to SSAP No. 43R for a description of securities subject to its provisions. The VOSTF Valuation of Securities (E) Task Force does not formulate policy or administrative procedures for statutory accounting guidance. Reporting insurance companies are responsible for determining whether a security is subject to SSAP No. 43R and applying the appropriate guidance.

(ii) Important Limitation on the Definitions of RMBS and CMBS
The definitions of RMBS and CMBS in Section 2 of this Part above are intended solely to permit the SVOSSG to communicate with financial modeling vendors, insurance company investors who own RMBS and CMBS subject to financial modeling and/or carrying value methodology and their investment advisors to facilitate the performance by the SVOSSG of the financial modeling methodology described below. The definitions contained in this Section are not intended for use and should not be used as accounting or statutory statement reporting instructions or guidance. Readers must refer to SSAP No. 43R for applicable accounting guidance and reporting instructions.
(iii) Analytical Procedures Applicable to RMBS and CMBS Securitizations Subject to Financial Modeling Methodology

1. Filing Exemption Status of RMBS and CMBS
RMBS and CMBS are not eligible for the filing exemption provided in Part Two, Section 4 (d) (i) of this Manual because credit ratings of CRPs are no longer used to set risk-based capital (RBC) for RMBS or CMBS. However, RMBS and CMBS are not submitted to the SVOSSG. Please refer to Section 4 (c) (i) of this Part and Part Three, Section 3 (a) of this Manual for related instructions.

2. Use of Financial Modeling for Year-End Reporting for RMBS and CMBS
Beginning with year-end 2009 for RMBS and 2010 for CMBS, probability weighted net present values will be produced under NAIC staff SVO supervision by an NAIC-selected vendor using its financial model with defined analytical inputs selected by the SVOSSG- and approved by the VOS/TF. The vendor will provide the SVOSSG- with a range of net present values for each RMBS or CMBS corresponding to each NAIC designation category. The NAIC designation for a specific RMBS or CMBS is determined by the insurance company, based on carrying value ranges. Please refer to SSAP No. 43R for guidance on all accounting and related reporting issues.

3. Analytical Procedures for RMBS and CMBS
The SVOSSG- shall develop and implement all necessary processes to coordinate the engagement by the NAIC of a vendor who will perform loan-level analysis of insurer-owned RMBS and CMBS using the vendor’s proprietary models.

a. RMBS and CMBS Subject to Financial Modeling

(i) Setting Microeconomic Assumptions and Stress Scenarios
Not later than September of each year, the SVOSSG- shall begin working with the vendor to identify the assumptions, stress scenarios and probabilities (hereafter model criteria) the SVOSSG- proposes to use at year-end to run the vendor’s financial model.

The VOS/TF shall schedule a regulator-to-regulator meeting so that it can consult with staff and the vendor on the proposed model criteria. The purpose of the regulator-to-regulator meeting is to permit the staff and vendor to explain its recommendations and how the analytical processes intended to be used will produce net present values of RMBS and CMBS, and as well as to permit the VOS/TF to provide policy direction that would assist the SVOSSG- in identifying the technical approaches most likely to secure the regulatory objective. The SVOSSG- shall incorporate whatever guidance is provided by the VOS/TF at this regulator-to-regulator meeting into the proposed model criteria and prepare a Proposed Model Criteria Document.

If directed by the VOS/TF, the SVOSSG- shall release the Proposed Model Criteria Document to the public in anticipation of a public meeting of the VOS/TF. The purpose of the public meeting is to provide an opportunity for insurance company investment managers with responsibility for RMBS and
CMBS to ask questions and comment on the proposed model criteria or process.

The SVOSSG is directed to consider the technical comments made by the industry and/or other interested persons during the public meeting. Subsequent to the meeting, the SVO shall prepare a questions-and-answers document in which it shall list and reply to the technical questions and concerns expressed at the public meeting. The SVOSSG may make whatever technical adjustments to the proposed model criteria it shall in its analytical discretion deem appropriate and publish a Final Proposed Model Criteria Document on its Web page.

(ii) The Financial Modeling Process

The SVOSSG shall obtain loan-level analysis of RMBS and CMBS using the selected vendor’s proprietary financial model.

The financial model used by the SVOSSG is expected to provide for each of the analytical steps that follow: a macroeconomic process, a mortgage loan credit process and a waterfall process.

The macroeconomic process projects the future performance of macroeconomic variables. These variables and various scenarios to be employed in this step of the financial modeling process will have been determined through the meetings described in subparagraph (i) above.

The mortgage loan credit process projects loan performance based on the projected macroeconomic variables and loan characteristics. The loan characteristics employed may be broadly identified and discussed in the Final Model Criteria Document to the extent the Valuation of Securities (E) Task Force deems it necessary to ensure attainment of regulatory objectives, but subject to legitimate commercial and proprietary interests of the financial model vendor.

The results of the mortgage loan credit model provide the scenario inputs to produce a tranche level cash flow “waterfall.”

What follows is, therefore, intended as a general description of one such process.

**LOAN-LEVEL ANALYSIS**

**RMBS –** Loan-level analysis begins with historical loan performance. Loans are classified as performing or non-performing. Based on loan characteristics and macroeconomic variables, transition probabilities are calculated. Because the parameters of the model are path-dependent, Monte Carlo simulation is used. A random drawing against these calculated probabilities decides the performance group or exit group (prepayment or default) that the loan will be assigned to during the next month. The loan-level prediction is then aggregated into pool level projected curve. For purposes of loss severity, the same default probabilities are applied to maintain consistency. Additional components that contribute to the ultimate loss severity analysis include collateral deficiency (unpaid balance less REO sales price), lost interest (accrued as servicer advances), expenses (legal fees, property taxes and brokerage fees) and mortgage insurance considerations.
CMBS – The vendor will review raw loan level data sourced from servicers and trustees for inconsistencies and inaccuracies, correcting the data where applicable. Based upon SVOSSG directions, the vendor will manually review and re-underwrite certain loans in each pool based upon size, credit history or other criteria at the discretion of the SVOSSG. In addition to loan level performance, the vendor’s analysis will reasonably take into account other factors known to bear on long-term property performance, such as age, size and locational characteristics. The vendor will then utilize market-derived income growth curves and capitalization rates to project the collateral performance of each loan in a given CMBS issue. Based on parameters and triggers such as debt service coverage levels, extension parameters and workout periods and costs, produce an outcome and loss estimate for each loan in the pool.

RMBS and CMBS

Once generated, pool cash flows are passed through the bond waterfall. The “waterfall” is a set of rules derived from the terms of the contract governing the RMBS or CMBS securitization that determine which bonds get paid principal and interest and how losses are distributed at a particular point in time. Waterfall models for individual RMBS and CMBS securitizations can be obtained from a reputable vendor (often referred to as a deal library).

The net present value for the insurer-owned RMBS or CMBS tranche is derived by applying a discount rate to the projected/probability weighted cash flow. In multiple scenario approaches, the mortgage credit model and waterfall model are used to calculate the present value of losses under each scenario.

The final valuation is the par value minus the probability weighted present value of losses. The interest rate used to discount the bond cash flow will be the bond coupon.

(iii) Validation of Modeled Results

The NAIC and SVOSSG staff shall ensure that the vendor has extensive internal quality-control processes in place. In addition, however, the SVOSSG shall conduct its own quality-control checks of the vendor’s valuation process.

(iv) Publication of Final Results

Upon delivery by the vendor of values for the RMBS and CMBS portfolio and subject to the final modeling process and completion of all SVOSSG quality control and validation processes, the SVOSSG shall cause the valuation file for the modeled insurer-owned portfolio to be delivered to other appropriate NAIC staff for dissemination to insurance companies.

(v) Use of Net Present Value and Carrying Value for Financially Modeled RMBS and CMBS

For each modeled RMBS and CMBS, the financial model determines the net present value at which the expected loss equals the midpoint between the RBC charges for each NAIC designation; i.e., each price point, if exceeded, changes the NAIC designation. Net present value is the net present value of principal losses, discounted using the security’s coupon rate (adjusted in case of original issue discount securities to book yield at original issue and in case of floating rate securities, discounted using LIBOR curve + Origination spread). Because of the difference in RBC charge, the deliverable is five values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and
five values for companies not required to maintain an AVR. This is illustrated in the chart below.

The NAIC designation for a given modeled RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer’s carrying value of each RMBS or CMBS, whether that carrying value, in accordance with SSAP No. 43R, paragraphs 25–26a, is the amortized cost or fair value, and where the carrying value matches the price ranges provided in the model output for each NAIC designation; except that an RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios and that would be equivalent to an NAIC 1 Designation if the filing exempt process were used, would be assigned an NAIC 1 Designation regardless of the insurer’s carrying value. Please refer to the detailed instructions provided in SSAP No. 43R.

### (iv) Analytical Procedures Applicable to Securities Not Subject to Financial Modeling Methodology

#### (A) Securities Not Modeled but Rated by an NAIC CRP and Subject to Modified Filing Exempt Process

- To obtain the NAIC designation for a CUSIP not modeled but rated by an NAIC CRP, please refer to the detailed instructions in SSAP No. 43R, paragraph 26b.
- Securities assigned an NAIC CRP credit rating equivalent to an NAIC 1 designation are assumed to have zero expected loss, and, therefore, the designation is not modified by the carrying value and remain NAIC 1. Securities assigned an NAIC CRP credit rating equivalent to an NAIC 6 designation are not modified by the carrying value and remain NAIC 6.
- The Table below is used to implement the carrying value methodology for securities that are subject to modified filing exempt process SSAP No. 43R, except Excluded Securities as defined in subsection (C) below.

### Table One

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<th>NAIC Designation Breakpoints for Loan Backed and Structured Securities</th>
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### P&C & Health  

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<td>82.69</td>
<td>86.25</td>
<td>100.00</td>
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</table>

Designation changes when carrying value exceeds the breakpoint

### (B) Securities Not Modeled by the SSG and Not Rated by an NAIC CRP or Designated by the SVO

Securities subject to SSAP No. 43R, that cannot be modeled by the SSG and are not rated by an NAIC CRP or designated by the SVO, are either (X) assigned the NAIC administrative symbol NR (not rated), requiring
subsequent filing with the SVO, or (Y) assigned the NAIC designation for Special Reporting Instruction; i.e., an 
NAIC 5* or NAIC 6* (five-star or six-star), as discussed in Part Two, Section 5 of this Manual.

(C) Exclusion of Certain Securities from Application of Carrying Value Methodology for Non Modeled 
Securities
(1) Exclusion and Excluded Securities
The carrying value methodology described in subsection (iv) A, above, shall not apply (the Exclusion) to Credit 
Tenant Loans, Equipment Trust Certificates (whether rated by an NAIC CRP or designated for quality by the SVO) 
or to every other individual security to which the SVO has assigned an NAIC Designation, (collectively, “Excluded 
Securities”), effective with the 2011 year-end reporting cycle. Please refer to SSAP No. 43R, paragraph 26c.

(2) Deriving NAIC Designations for Excluded Securities
The NAIC Designation for Excluded Securities that are Credit Tenant Loans or Equipment Trust Certificates shall 
be the credit rating assigned by CRPs after application of the filing exemption procedure described in Part Two, 
Section 4 (d) (i) of this Manual or the NAIC Designation assigned by the SVO. The NAIC Designation for Excluded 
Securities that are individual securities to which the SVO has assigned an NAIC Designation, shall be the NAIC 
Designation assigned by the SVO. Please refer to SSAP No. 43R, paragraph 26c.

b) Mortgage Referenced Security
(A) Definition
Mortgage Referenced Security is a category of a Structured Note, as defined above in Part Three, Section 3 (b) (vi) of this Manual.

In addition to the Structured Note definition, the following are characteristics of a Mortgage Referenced Security:

A Mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, or assets deriving their value from instruments related to real estate, including, but not limited to, mortgage loans.

(B) Not Filing Exempt
A Mortgage Referenced Security is not eligible for the filing exemption in Part Two, 
Section 4 (c) (ii) or the filing exemption in Section 4 (d) of this Manual, but is subject 
to the filing requirement indicated in Part Two, Section 2 (a) of this Manual.

(C) NAIC Risk Assessment
In determining the NAIC designation of a Mortgage Referenced Security, the SSG may 
use the financial modeling methodology discussed in this Part Seven, Section 6(a), 
adjusted to the specific reporting and accounting requirements applicable to Mortgage 
Referenced Securities.

c) The RTAS – Emerging Investment Vehicle
(a) Purpose
Price grids are generated for the exclusive use of insurance companies and the NAIC 
regulatory community. Insurance companies use official Prices Grids by following the 
instructions in SSAP No. 43R, Loan Backed and Structured Securities, to derive a 
final NAIC Designation for the RMBS or CMBS, which they use to derive the RBC
applicable for the RMBS or CMBS. Please refer to SSAP No. 43R for a full explanation of the applicable procedure.

(b) Extension of Authority
The procedure specified in Part Four, Section 3 (a) of this Manual for the SVO is extended to the SSG, and the SSG is authorized to determine probable regulatory treatment for RMBS and CMBS pursuant to Section 5 (a) of this Part Seven or for other securities, where, in the opinion of the SSG, financial modeling methodology would yield the necessary analytical insight to determine probable regulatory treatment or otherwise enable the SSG to make recommendations to the VOS/TF as to regulatory treatment for a security, as discussed in Part Four, Section 3 (a) (ii) of this Manual.

(c) Interpretation
To facilitate this purpose, wherever in Part Four, Section 3 (a) (ii) of this Manual, reference is made to the SVO, it shall be read to also refer to and apply to the SSG, adjusting for differences in the operational or methodological context.

Part Four, Section 3 (a) (ii) of this Manual shall also be read as authority for collaboration between SVO and SSG Staff functions so as to encompass RTAS assignments that require the use of SVO financial, corporate, municipal, legal, and structural analysis and related methodologies, as well as of financial modeling methodologies.

(d) Translation of Preliminary into Official Price Grids
Price Grids generated by the SSG pursuant to an RTAS under this Section 6 (c) of this Part are preliminary within the meaning of that term as used in Part Four, Section 3 (a) (ix) of this Manual and accordingly cannot be used for official NAIC regulatory purposes.

Preliminary NAIC Designations are translated into official NAIC Designations by the SVO when an insurance company purchases and files the security and the SVO conducts an official assessment. However, the Purposes and Procedures Manual does not require the filing of RMBS and CMBS subject to financial modeling methodology with the SSG. It is, therefore, necessary to specify a procedure for the translation of preliminary Price Grids into official Price Grids that can be used for NAIC regulatory purposes.

Preliminary Price Grids generated by the SSG become an official Price Grid within the meaning of this Section when an insurance company has purchased the security for which the Price Grid was generated and reported that security for quarterly reporting purposes using the SSG generated Price Grid.

A Price Grid for a security reported by an insurance company for quarterly reporting is effective until the SSG conducts the next annual surveillance pursuant to Section 6 (a) of this Part, at which the time the Price Grids generated by the SSG at yearend shall be the official Price Grid for that security.
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Valuation of Securities (E) Task Force

FROM: Robert Carcano, Senior Counsel, NAIC Investment Analysis Office
       Harry Olsen, Manager II, NAIC Securities Valuation Office Credit Assessment/Valuation Group
       Robert Nelson, Senior Analyst, NAIC Securities Valuation Office Credit Assessment & Valuation Group

CC: Charles Therriault, Director, NAIC Securities Valuation Office

DATE: February 26, 2015

RE: Non-Recourse Loans

1. **Introduction** – The SVO was asked to discuss transactions called non-recourse notes and an SVO Senior Credit Committee decision to delete them from the VOS Database.

2. **Structure** – In a non-recourse note, an entity that derives its income from charitable contributions makes mortgage loans or business loans to persons who meet its charitable criteria. The entity then issues notes, either directly or through an intermediary, secured by the loan(s) it has made. Payment of interest and principal on the notes is made solely from the principal and interest paid by the loan recipient.

3. **Methodology** – Because the issuer has no legal responsibility to pay the notes, SVO methodologies, which require an assessment of the issuer’s audited financial statements, cannot be used to assess likelihood of payment. Quantification of the likelihood of payment or default requires financial modeling, which, in turn, requires reliable historical data about the loans. Such data is not available for charitable loans.

4. **Population** – To date, the SVO identified 51 non-recourse CUSIPs in the VOS Database (Attachment Two). Thirteen (11 issued by Community Preservation Corp.) were deleted during the 2014 annual review process. Thirty-eight CUSIPs (14 issued by Habitat for Humanity [HFH], 17 issued by Community Preservation Corp. and 7 issued by individual issuers) have been identified for deletion. A preliminary review of documentation indicates approximately 14 other transactions may not be non-recourse notes in that there is recourse to an issuer who can provide audited financial statements.

5. **Statutory Accounting** – The status of non-recourse notes under the NAIC statutory accounting framework is unclear. Non-recourse notes do not state an obligation to pay. The loans are made on the basis of charitable criteria, so their viability as a financial asset is questionable. The payment structure is not obligor-based and, therefore, does not fit the pattern of Statement of Statutory Accounting Principles (SSAP) No. 26—Bonds, Excluding Loan-Backed and Structured Securities. Pass-through of cash flow from loans suggest similarity to SSAP No. 43R—Loan-Backed and Structured Securities – Revised payment patterns, but a comparison of the structure to residential mortgage-backed securities (RMBS) (in the case of HFH notes) indicates the HHF CUSIPs would not be eligible for financial modeling as RMBS as defined by the NAIC. (HFH notes are secured by the general obligation of HFH affiliates, backed by 0% mortgages on low-income housing. Non-performing loans are replaced with “surplus notes,” with a limited recourse of 5% to HFH. (See Attachment One for a schematic of the structure.)

6. **Conclusion** – Non-recourse notes cannot be assessed for credit quality by SVO or Structured Securities Group (SSG) methodologies and do not appear to meet SSAP No. 4—Assets and Nonadmitted Assets, SSAP No. 26 or SSAP No. 43R...
criteria. To the extent they can be characterized as an investment, non-recourse notes most resemble a residual interest in a project of a charitable organization.

Attachment One
Habitat Structure

Exhibit A – Structure of Loan

attachment = Flexcap Loan

Homeowner Loans = 125% Affiliate Loans

Affiliates can only pledge a portion of loan portfolio. Obligated to use surplus loans to replace non-performing pledged loans

G:\DATA\Vos-tf\Meetings\2015\June 2, 2015\02 TaskForce Rpt on Non-Recourse Notes in VOS Database.docx
## Attachment Two - Non-Recourse Transactions in VOS Database

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<tr>
<th>Name</th>
<th>CUSIP</th>
<th>ATF Deleted?</th>
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May 14, 2015

Mr. Stewart Guerin, Chair
NAIC Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Re: Non-Recourse Loans to Charitable Organizations

Dear Mr. Guerin:

The American Council of Life Insurers (ACLI)\(^1\) appreciates the opportunity to provide comments on the discussion of Non-Recourse Loans to Charitable Organizations.

While ACLI agrees with the SVO that, if they believe that the status of the non-recourse notes under the NAIC statutory accounting framework is unclear, then this is a matter for the Statutory Accounting Principles Working Group (“SAPWG”) to consider and we support referral to the SAPWG. We are concerned that the Valuation of Securities (E) Task Force (VOSTF) has not opined on the unilateral decision by the SVO to delete securities from its database when the appropriate protocol would have been to notify the VOSTF. The VOSTF should be involved in any future decisions regarding analytical changes or removal of investments from the SVO databases. The NR* Regulatory Review process is available for these scenarios.

ACLI believes the subject of this proposal is inaccurate and gives the reader the impression that all Non-Recourse loans are under scrutiny. Non-Recourse Loans represent a much wider universe than the investments actually identified within this proposal. The SVO’s proposal is dissecting loans to charitable organizations, and specifically those that may not have recourse to the obligor.

We thank you for allowing us to comment on this memorandum and look forward to discussing this with you further.

Sincerely,

[Signature]

Mike Monahan
Senior Director, Accounting Policy

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\(^1\) The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with 284 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at [www.acli.com](http://www.acli.com).
24 April, 2015

Stewart Guerin
Chief Examiner
Louisiana Department of Insurance
Via email: sguerin@ldi.state.la.us

Re: Memorandum Exposed by the Valuation of Securities Task Force: “Non-Recourse Loans”
February 26, 2015

Dear Mr. Guerin,

In your capacity as chair of the NAIC’s Valuation of Securities Task Force (the “Task Force”) please accept these comments concerning the captioned memorandum. These views are my own as an individual who has followed the work of this Task Force for more than a score of years.

I agree that the first element of the conclusion of the memorandum could be true: “Non-recourse notes [sic.] cannot be assessed for credit quality by SVO or Structured Securities Group (SSG) methodologies…” And, in fact, this presents no issues for the Task Force or insurers in view of the 5* 6* Rule.

On the other hand I believe the second element of the conclusion is incorrect. The statement that the subject securities “…do not appear to meet SSAP No. 4—Assets and Non-admitted Assets, SSAP No. 26 or SSAP No. 43R” appears to be based on the statement that “Non-recourse notes do not state an obligation to pay”. It is obvious that this is not a correct statement.

I discuss these inconsistencies here, but please note that in my comment letter responding to the January 12, 2015, staff proposal I describe how the staff is required to submit securities such as this for Regulatory Review rather than proposing modifications to the Manual as they do in that proposal.

Concerning the assets detailed in Attachment Two of the memorandum, we know perfectly well that what are generally called non-recourse loans or notes certainly do state obligations to pay (or repay) lenders. There are tremendous numbers of non-recourse notes and I am not familiar with any that do not state an obligation to pay. After all, that is why they are called loans or notes. They promise repayment. Otherwise they would be gifts.

But part of the confusion in this memorandum stems from the fact that it is not actually referring to the thousands and thousands of non-recourse notes in general. Instead it defines non-recourse notes as a very special and unusual subset of the far larger universe of actual non-recourse notes.
For the purposes of this letter and for greater precision I will call these socially responsible investments in affordable housing (or SRIAHs) to avoid this confusion. Unfortunately the memorandum uses the term non-recourse notes when it actually means SRIAHs and it is this unconventional terminology that leads to confusion.

As detailed in the memorandum what I call SRIAHs are described as asset-based loans paying principal and interest with no recourse and that are originated by charitable entities. So let us examine each of these elements to see if there is anything unusual about any of them.

First, there is nothing unusual about asset-based loans. They are nearly as old as commerce itself (borrowing against the family jewels) and as modern as today (residential mortgage loans). Given the appropriate data, qualified financial analysts certainly can form credit opinions regarding asset-based loans.

Similarly there is nothing unusual about recourse. Recourse (or a guarantee) can simply be an enhancement to an asset-based loan. So recourse can be a credit plus. On the other hand a lack of recourse is only credit neutral (but not a minus). If analysts are to give credit for recourse to an entity then they must assess its creditworthiness. While this may complicate the analysis it is certainly possible to do this, again, given sufficient financial information. So just as there is nothing particularly unusual about an asset-based loan with recourse there is nothing unusual about its absence.

Third, there is nothing unusual about analyzing a charitable organization as an obligor. An analyst would use the same standards as for any other obligor. Is it obliged to make payments? Is it willing to make payments? Is it able to make payments? Against these standards some charitable organizations might fare quite poorly. On the other hand the Bill & Melinda Gates Foundation would probably do very well.

Given sufficient financial information a qualified analyst would be capable of developing a credit opinion for these SRIAHs. But here the staff is stating that the financial information available to the NAIC is *not* sufficient. This means that the NAIC cannot perform a credit analysis. We also know that the Task Force has directed the SVO/SSG not to “classify” securities (*i.e.* perform “classification analysis”). As the memorandum concludes, the NAIC cannot analyze these securities so, we ask, where does this leave us?

The simple answer would be the 5* 6* Rule. But the memorandum claims that for SRIAHs there is no obligation to pay. The memorandum also states, however, that principal and interest *is* paid by loan recipients so in fact there *is* a loan. If there were no promise to pay then these would not be loans at all. In the parlance of this memorandum these then would be non-recourse non-loans.

I believe that the staff should have requested a Regulatory Review from the Task Force as it is required to do when “analytical instructions are insufficient or inadequate”. A Regulatory Review would then have evaluated the assets themselves against the points specified above. I have said previously that if nothing is received for value given then a payment is a gift and certainly not a loan. I cannot anticipate what the argument might be that the loans in question are not promises, and that argument has not been made. This entire matter can be clarified in a Regulatory Review.
How Can it Be Determined Whether a SRIAH is Subject to SSAP No. 43R?

As it turns out I believe it is relatively easy to determine whether or not an individual SRIAH is a Loan-Backed or Asset-Backed Security (“LBAS”) subject to SSAP No. 43R. Here are the tests:

1) Is there an underlying loan, note, mortgage or other similar promise? and
2) Is the owner of the SRIAH (or another asset) entitled to the proceeds of the underlying loans, notes, mortgages or similar promises to the extent that the payment terms of the SRIAH are satisfied?

If the answer to either question is negative then the security is not an LBAS. If, however, the answers to both questions are affirmative then it is very unlikely that it would comport with the other specifications of SSAP No. 43R.

Conclusion

So, clearly there has been considerable confusion in terms of nomenclature, definitions and process and this is precisely the circumstance under which Regulatory Review is mandated. Most likely a Regulatory Review will conclude that if a loan is a loan then it is an asset under SSAP No 4. If it is not a loan then it is not a loan. Staff has ample opportunity to specify facts in its Regulatory Review documentation so this is an opportunity for clarification. From my vantage point, however, I do not know how it is possible for loans not to have promises. According to the Manual, then, SRIAHs are entitled to 5*6* treatment pending the Regulatory Review.
SECTION 2. POLICIES DEFINING THE SVO STAFF FUNCTION...

…f) Process for Placing Securities Under Regulatory Review; When Analytical Instructions Are Insufficient or Inadequate

(i) Notice
The Director shall promptly inform the Chair of the VOS/TF of his or her conclusion that market or other developments; the aspects of a new or existing security, financial instrument or analytical situation, requires the NAIC to formulate new financial solvency policy or develop new or additional instructions and or methodologies for the SVO. The Director shall prepare a written report for the VOS/TF explaining the reasoning that led to the conclusion.

(ii) Deliberation
The Chair shall call a meeting of the VOS/TF to consider and discuss the SVO report and the issues it presents and to consider how to proceed. If the VOS/TF determines that the nature of the security and/or the issues raised by the SVO requires formulation of new policy or regulatory instructions or the development of new or additional instructions and/or methodologies, the VOS/TF shall consider whether to declare the security or financial product to be under regulatory review.

On its own initiative or at the direction of the NAIC Executive Committee, the Financial Conditions (E) Committee may instruct the VOS/TF to place a security under regulatory review. The VOS/TF may, on its own initiative place a security under regulatory review as discussed in this section.

(iii) Hearing and Declaration
If the VOS/TF is instructed or if it determines that a security should be formally declared to be under regulatory review, it shall hold a public hearing to discuss the issue and make a formal declaration of this decision. The staff shall cause notice of the determination to be published to interested persons and to other NAIC groups that have jurisdiction over reporting issues, have relevant expertise or would be affected by the activities of the VOS/TF.

(iv) Reporting Framework for Securities under Regulatory Review
Upon a public declaration that a security is under regulatory review, insurance companies that own the security shall report it on the NAIC Financial Statement Blank with the administrative symbol NR* if the security is under review for an assessment of regulatory policy for the investment or regulatory reporting instructions to implement applicable policy or with the administrative symbol Z* if the security is under regulatory review for development by the VOS/TF of the instructions or methodologies for application by the SVO in its risk assessment.

In September of each year, the VOSTF will publicly identify which classes of securities, if any, are under regulatory review and therefore eligible to take the regulatory treatment prescribed for NR*/Z* in the Annual Statement Instructions for that year’s year-end NAIC Financial Statement Blank.

(v) Filing of Securities under Regulatory Review
Unless the VOS/TF shall provide other instructions to insurance
companies, securities under regulatory review that are otherwise reportable to the SVO shall continue to be filed with the SVO during the period of regulatory review.
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office

DATE: January 12, 2015


1. Issue and Summary Discussion - Part Two, Sections 5 of the Purposes and Procedures Manual is a Special Reporting Instruction commonly called the 5*/6* Rule (pronounced five-star/six-star). Section 5 (f) and (g) of the Rule permit insurers to obtain a 5* or a 6* from the SVO upon a certification that the insurer lacks documentation necessary for the SVO to assign an NAIC Designation but is receiving agreed upon payments and expects to continue to do so. Section 5 (f) and (g) also provide that the SVO may assign NAIC 5* and NAIC 6* Designations to structured securities. The SVO has determined that the phrase refers to a group of complex corporate securities in Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual. Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual refers to these securities as structured securities and to the SVO function assigned to evaluate them as the SVO structured securities group. In addition, the NAIC Proceedings indicate that a primary concern of Section 5 (f) and (g) was insurers that could not report securities to the SVO because they lacked the legal right to require the issuer to obtain an Audited Financial Statement. This confirms that the phrase refers to the complex corporate securities in Part Three, Section 3 (a) and (b) because credit assessment of such securities requires an Audited Financial Statement while the assessment of securitizations would not. The NAIC Proceedings also show that the Rule was intended to apply to securities required to be filed with the SVO. This would also confirm that Section 5 (f) and (g) does not apply to securitizations because the SVO was never assigned a securitization assessment mission. The SVO therefore recommends that Section 5 (f) and (g) be amended to refer to Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual.

2. Background

(i) The 120-Day Rule and Self-Designation under the Z Process – A security subject to filing with the SVO is required to be filed within 120 days after purchase (the 120-day rule). Because the SVO may not be able to provide an NAIC Designation to the insurer for a security purchased in the year-end time period, a rule was created to permit insurers to self-designate a security and report it to regulators (the Z Rule) with the administrative symbol Z, provided they comply with the 120-day rule. The expectation was that the SVO would assign a designation to the security in the addendum period or in the next reporting period.
(ii) **Concern with Misuse of the Z Process** – In 1995, after identifying several populations of perpetually self-designated bond populations, the SVO proposed that it be permitted to assign NAIC 5 Designations to such securities. The Invested Assets (E) Working Group found that insurers owned and were perpetually self-designating securities for which they lacked a legal right to require the issuer to obtain an audited financial statement or where the cost of translating financial information into English to permit an SVO assessment would be prohibitively high.

(iii) **Regulator Intent** - The record indicates that the Task Force adopted the Rule to require the filing of financial information for securities that were required to be filed with the SVO to provide the NAIC with analytical judgments about the quality of securities produced by the SVO. Section 5 (a) and (b) of the Rule provided an insurer that self-designated a security during the first reporting period after purchase must file the security with the SVO for a designation or a 5* or 6*. Specific solutions for certain populations of securities identified by the Working Group were developed and inserted in Section 5 (i) of the Rule. The Rule was effective with the 1999 year-end process.

(iv) **Conclusions** – The NAIC Proceedings show that the 5*/6* Rule was a response to known population of securities. Section 5 (i) and other sections of the *Purposes and Procedures Manual* shows the Task Force preferred to identify specific populations eligible for 5* or 6*. Section 5 (f) and (g) was created for a relatively small remaining population(s). This approach would be consistent with the determination to rely on analytically determined designations and with the fact that 5*/6* legitimizes securities as an admitted asset and should therefore be applied only when characteristics of securities are known.

The phrase structured securities in Part 5 (f) and (g) refers to a specific group of complex corporate securities and not to securitizations. The *Purposes and Procedures Manual* has for some time referred to a group of structurally complex corporate securities as structured securities or transactions and to the SVO staff segment responsible for assessment of this population of securities as the structured transaction group.

The only reference to securitizations in the *Purposes and Procedures Manual* occurs in relation to the financial modeling of RMBS and CMBS in Part Seven of the *Purposes and Procedures Manual*. Part Seven provides that an RMBS or CMBS that cannot be modeled (due to lack of information in deal libraries) and that is not rated by a credit rating provider (CRP) (so that the modified filing exemption rules does not apply) would be filed with the SSG for a 5* as part of financial modeling methodology per Section 5 (i) of the Rule.

Section 5 (f) and (g) cannot reasonably be read to apply to securitizations because the Rule applies only to securities that are required to be filed with the SVO. Securitizations were never required to be filed with the SVO, except during 2009-2011 when the NAIC adopted financial modeling as discussed above. Financial modeling is now conducted by the SSG.

The NAIC Proceedings indicate that the population of securities that insurers were self-designating could not be filed with the SVO because the insurer could not require the issuer to obtain an Audited Financial Statement. Securitizations are not assessed using audited financial statements.

The SVO therefore recommends that Section 5 (f) and (g) be amended to refer to Part Three, Section 3 (a) and (b) of the *Purposes and Procedures Manual*.

### 3. Information about the 5*/6* Population

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<td>375</td>
<td>359</td>
</tr>
<tr>
<td>Overall Exposure</td>
<td>$9.1 Billion</td>
<td>$8.7 Billion</td>
<td>$1.7 Billion</td>
</tr>
</tbody>
</table>
The table above shows an increase in the size of the population, based upon overall dollar exposure, of more than 435% within the last three years.

<table>
<thead>
<tr>
<th>2013</th>
<th>Quarter 1</th>
<th>Quarter 2</th>
<th>Quarter 3</th>
<th>Quarter 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>VOS 5*/6* Issues</td>
<td>9</td>
<td>23</td>
<td>102</td>
<td>211</td>
<td>345</td>
</tr>
<tr>
<td>% Total</td>
<td>2.6%</td>
<td>6.7%</td>
<td>29.6%</td>
<td>61.1%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

In the above table, we isolate the 5*/6* population as of Dec. 31, 2013. The table shows 345 of the 391 unique CUSIPs were filed and reviewed after September; i.e., 77 in September, 69 in October, 21 in November and 121 in December, for a total of 83.4% (288/345).

The table above breaks down the 345 securities assigned 5* or 6* in 2013 into the three major categories affected.

4. Conclusion - The SVO recommends that Section 5 (f) and (g) be amended to refer to Part Three, Section 3 (a) and (b) of the Purposes and Procedures Manual to identify the intended meaning of the phrase “structured securities” in the SVO context.

END NOTES

1 Part Two, Section 7
2 Part One, Section 3 (b)(v)
3 “… the Working Group reviewed and then requested comments on the (SVO’s) … "Z" rated bond proposals requiring audited statements … Comments were made relating to … grandfathering certain securities, Canadian municipals exempted from audited statement requirements by the … (SEC), and foreign securities owned in support of foreign liabilities. Commenters were asked (to document) their requests for exemption. The Working Group … adopted a motion stating that the "Z" notation was "intended to be a temporary solution to the problem of obtaining a SVO rating on a fixed income security" and "was never intended to be a basis for avoiding the requirement for obtaining" such a rating ...
modified proposal which is similar to the one presented in St. Louis and send … to the … Working Group for accounting issues … NAIC Proceedings 1995, 3rd Quarter at 532.

5 “… certain barriers exist that will prevent full compliance. Among [them] … lack of authorization in older notes/debentures … (allowing) insurers to pursue obtaining newly requested documents or financials; … In many cases, the (insurer’s) cost … is disproportionate to the income generated. The nature of these securities is such that insurers are virtually certain that they will mature in accordance with their terms … Foreign securities continue to be a vexing issue for the SVO.” NAIC Proceedings 1995, 3rd Quarter, at 534.


8 A third component of the 5*/6* process consists of a series of permitted usages tied to specific analytical situations. All of them restrict the discretion of the SVO to assignment of the non-analytical 5* or 6* symbols instead of the analytical symbols NAIC 5 or 6.

9 The Purposes and Procedures Manual did not directly refer to the sections describing the population to which the phrase structured securities referred because well-known NAIC reliance on NRSRO credit ratings for structured finance was well-known. What is now Part Three (a) and (b), however, always did identify those securities deemed to be within the scope of the “SVO’s Structured Transactions Group.” This phrase that has been used in the Purposes and Procedures Manual for some time before 2011 and is, in fact, still used as shown below.

“(b) Other Transactions under Auspices of the SVO Please refer detailed questions about the analytical or other procedures applied to these securities to the SVO Structured Transactions group. (i) Structured Lottery Securities … (ii) Military Housing Bonds … (iii) Credit Tenant Loans … (iv) Replication (Synthetic Asset) Transactions … (v) Catastrophe-Linked Bonds … (vi) Structured Notes … (vii) Residual Tranches of ABS, RMBS and CLOs and CDOs … (viii) Principal Protected Notes (ix) Exchange Traded Funds … (Emphasis added) Source: Purposes and Procedures Manual, published December 31, 2014.

10 See, Part Seven, Section 5 (a) (iv) (B) of the Purposes and Procedures Manual. It is also worth noting that RMBS and CMBS are not, in fact, reported to the SVO or the Structured Securities Group (SSG) but to the NAIC as part of the general insurer financial statement reporting process as part of the limited filing exempt provided in Part Seven, Section 4 c of the Purposes and Procedures Manual. ABS and other securitizations or structured transactions are still subject to credit rating methodology and are CRP-rated filing exemption in Part two, Section 4 d and, therefore, not subject to filing with the SVO or the SSG.

11 Part Two, Section 5 (a)

12 There were a number of regulatory projects concerned with understanding and deciding how to regulate various populations of real estate related securities. One such project began with consideration of credit tenant loans and evolved into an assessment of commercial mortgage-backed securities (CMBS) and real estate investment trusts (REITs). Another project was concerned with how to regulate residential mortgage-backed securities (RMBS).

See NAIC Proceedings, 1995, 2nd Quarter at 418, 442 and 467 for discussions on the project concerned with building a framework for real estate-related securities that encompassed credit tenant loans, as well as REITs and CMBS. Under this project, an initial decision was made that CMBS would be eligible for Schedule D reporting if they are rated by an approved Nationally Recognized Statistical Rating Organization (NRSRO). As early as 1995, under this project, the Task Force determined that CMBS rated by an NRSRO would be eligible for reporting on Schedule D. NAIC 5*, and NAIC 6* was extended to CMBS when the 5*/6* Rule was finalized.

The Task Force was also called upon to address structured securities as a whole (i.e. RMBS, CMBS, asset-backed securities [ABS], collateralized mortgage obligations [CMOs], collateralized debt obligations [CDOs] and collateralized loan obligations [CLOs]) in a separate project in part because the SVO had assigned YES/NO designations to RMBS but could not convert these designations when the new NAIC 1-5 Designation framework was implemented citing lack of analytical capabilities and resource constraints to properly assess credit risk. This project was referred to as the Phase I – III Project, which was concerned with how to provide NAIC Designations to insurer-owned structured securities. See NAIC Proceedings 1996 1st Quarter at 542 (Attachment Five – A) for the SVO proposal. Under the proposal, Phase I involved structured securities assigned monitored credit ratings by NAIC AROs. Insurers would report these to the SVO, and the SVO would convert the ratings into NAIC Designations and into these values in the VOS Database. Phase II involved transactions once rated but where the insurer could not provide evidence of a currently confirmable NAIC ARO rating. RMBS and other securitizations could be assessed by the SVO on the basis of core documents but CMBS could not. Phase III involved RMBS and CMBS transactions never rated by an NAIC ARO. These could be submitted for an NAIC 5*/6* under the third component of the Rule; quoted below. See also NAIC Proceedings 1996, 3rd Quarter Vol I at 762, 1996, 4th Quarter, Vol 1 at 921 with respect to Phase III and NAIC Proceedings 1998, 2nd Quarter Vol 1 at 498, 541 – 548, 551

“Other Permitted Uses of Principal and Interest Certification Form and the NAIC 5* and 6* Designations … (ii) Residential Mortgage Backed Security (RMBS) The …. Form and the NAIC 5* and 6* Designations may be used in connection with an RMBS that has never been rated by an NAIC ARO as specified in Part Seven, Section 4 (b) (ii) (B) (5) of this Manual. (iii) Commercial Mortgage Backed Securities (CMBS) The … Form and the NAIC 5* and 6* Designations may be used in connection with a CMBS that has never been rated by an NAIC ARO as specified in Part Five, Sections 3 (c) (ii) (F) and 4 (e) (iii) (A) (3) (F) and Part Seven, Section 4 (b) (ii) (B) (6) of this Manual. Purposes and Procedures Manual Dec. 31, 2009, Part Four, Section 3(h) (ii) and (iii) at Part Four/Page 9

Note: RMBS – Part Seven, Section 4 (b) (ii) (B) (5) stated that RMBS never rated by an NAIC ARO were first subject to the methodology discussed in 4 (b) (iii) (B) (1) Transactions. Note that an NAIC ARO, Residential Mortgage Quality Matrix Procedure, or in lieu the insurer could request assignment of an NAIC 5* or 6* (at Pages Seven/ 32 and Seven/36. CMBS - Part Five, Sections 3 (c)(ii) (F) Part Five/Page 9) required unrated CMBS to be filed with the SVO and limited the SVO to assignment of an NAIC 5* or 6*. 4 (e) (iii) (A) (3) (e) provided the same instructions but for annual update filings. Part Seven, Section 4 (b) (iii) (B) (6) is the CMBS component of the same instruction discussed for RMBS above.

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13...the working group reviewed and then requested comments on the (SVO's)..."Z" rated bond proposals requiring audited statements... Comments were made relating to...grandfathering certain securities, Canadian municipals exempted from audited statement requirements by the... (SEC), and foreign securities owned in support of foreign liabilities. Commenters were asked (to document) their requests for exemption. The working group...adopted a motion stating that the "Z" notation was "intended to be a temporary solution to the problem of obtaining a SVO rating on a fixed income security" and "was never intended to be a basis for avoiding the requirement for obtaining" such a rating...

Industry asked that the Invested Assets (E) Working Group exempt (from the operation of the SVO proposed rule): 1) Municipal securities...issued before July 1, 1995, because the SEC adopted a rule to require issuers to file additional information with municipal and state securities information repositories, often including audited annual financial statements...[making] it likely...audited financial statements will be available...Insurers...have no contractual right to (ask) the issuers (for) audited financials. 2) Adopt the SEC's exemption for municipal issues...for $10 million or less in outstanding issues... small communities may not incur the additional cost of having their financial statements formally audited...3) Modify the...rule (as it applies to)...revenue obligations from issuers without audited financial statements...[data shows] revenue obligations in the 0.5% overall default rate...4) Review...the rule if SVO improvements are inadequate."

"See, NAIC Proceedings 1995, 2nd Quarter at 438, 465 for the original proposal. The original proposal included some of the analytically specific situations which were added to what we refer to as the third component of the Rule. What follows is a slightly revised proposal submitted by the SVO to accommodate comments made for the first proposal."...Proposal: The SVO proposal recognizes the original intent of the Z suffix, (is to permit)...insurers to show investments on their Schedule Ds...purchased too late in the year to receive a value in time from the SVO. The insurer is allowed to self-rate the investment, with the understanding that the investment would be submitted to the SVO for a value within 120 days...securities which held the Z suffix would receive a valid SVO rating by the time the next annual Valuations of Securities manual...SVO management (discovered) that there were a number of insurance companies...using the Z suffix as a way to carry investments on their books for which they had little or no information...To deal with those investments for which the insurers themselves cannot obtain any information, the SVO proposed the following guidelines...The Z suffix will remain as it was intended...If the security is not submitted to the SVO and a rating obtained within a year's time after the Z designation is applied, the security would then be automatically rated a 5, so long as a letter was received by the SVO from the insurer stating that the insurer was current on its contractual principal and interest payments. If such a letter was not received by the SVO, the issue would either: a) Drop to a NAIC-6 and be priced at Zero or b) become a nonadmitted asset...There are some exceptions and latitude...spelled out in detail in our original proposal...The SVO, therefore, requests that the Invested Assets (E) Working Group consider this modified proposal which is similar to the one presented in St. Louis and send [it]...to the...Working Group for accounting issues...NAIC Proceedings 1995, 3rd Quarter at 532.

"...certain barriers exist that will prevent full compliance. Among [them]...lack of authorization in older notes/débentures...(allowing) insurers to pursue obtaining newly requested documents or financials;...In many cases, the (insurer's) cost...is disproportionate to the income generated. The nature of these securities is such that insurers are virtually certain that they will mature in accordance with their terms...Foreign securities continue to be a vexing issue for the SVO."


See, NAIC Proceedings, 1995, 2nd Quarter at 418, 442 and 467 for discussions on a project concerned with building a framework for real estate.

14 The table below shows the 5*/6* RMBS/CMBS population for 2013, filed under the third component of the Rule applicable to financially modeled securities. An enhancement to NAIC systems prevents filers from creating ATFs for the population of securities subject to financial modeling. If an insurer attempts to file an RMBS or a CMBS with the SVO the following message:

This CUSIP has currently beenmodeled as either a RMBS or CMBS.

Refer to the Structured Securities Initiative Website for additional guidance;

displays in the ATF section and in the Inquiry Service to alert the filer of the security's status. A direct link to the NAIC Structured Securities Initiative web page is provided should the filer wish further guidance. The securities shown below were assigned 5*/6* under the third component of the Rule pursuant to and consistent with the financial modeling methodology.

<table>
<thead>
<tr>
<th>Structured</th>
<th>Total Unique CUSIPs</th>
<th>BACV ($million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RMBS</td>
<td>7</td>
<td>$2.9</td>
</tr>
<tr>
<td>CMBS</td>
<td>15</td>
<td>$24.5</td>
</tr>
<tr>
<td>Other (ABS, CMO, CLO, etc.)</td>
<td>35</td>
<td>$76.2</td>
</tr>
<tr>
<td>Total</td>
<td>57</td>
<td>$102.6</td>
</tr>
</tbody>
</table>
May 14, 2015

Mr. Stewart Guerin, Chair
NAIC Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197


Dear Mr. Guerin:

The American Council of Life Insurers (ACLI)\(^1\) appreciates the opportunity to provide comments on “The meaning of the phrase ‘structured securities’ in the Special Reporting Instruction in the Purposes and Procedures Manual of the NAIC Investment Analysis Office” (Purposes and Procedures Manual).

The proposal is described as a “structured securities” definitional change. However, the proposal content requests restriction or elimination of established NAIC Processes. The specific request focuses on the 5*/6* - Principal and Interest Certification.

The Principal and Interest Certification (5*/6*) developed out of a need. As we stated in our letter to the Task Force dated May 14, 2015, titled, “Discussion – Improvements to NAIC Systems and Rules Governing Insurer Filing of Securities with the SVO,” the 5*/6* process is the only option industry has in assigning an NAIC designation to unrated securities for which the SVO is unable to complete a full credit analysis. When filing for a 5* designation, the insurance company signs and submits a Principal and Interest Certification Form attesting that all documentation required by the SVO is not available, that the issuer is current on principal and interest payments, and is ultimately expected to make all required interest and principal payments. When filing for a 6* designation, the company is attesting that all required documentation is not available and that it cannot certify that the principal and interest payments are current, nor that ultimate payment of principal and interest will be made. This process is relevant in that it is needed by industry to report an unrated security as an admitted asset and to determine its RBC treatment.

\(^1\) The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with 284 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at www.acli.com.
Industry currently uses the 5*/6* process for:

- Foreign holdings in which the countries' audited financials are not accepted by the SVO
- Securities where all documents requested by the SVO cannot be delivered
- Investments with start-up companies which cannot meet the SVO requirement of 3 years' historical financials
- Securities that the SVO does not have the expertise to analyze and designate (Ex. - catastrophe bonds)
- Structured Securities that are not financially modeled and do not have a current NAIC CRP rating

ACLI would support adding an Interrogatory to the Annual Statement in which the insurer would attest that all securities in the Annual Statement with a 5* designation are current as to Principal and Interest. This Interrogatory would remove the SVO from the 5*/6* process.

Defined NAIC processes, to assign NAIC designations, existed for most SSAP-allowed investments. Most investments were rated by some prescribed NAIC methodology, including analysis by the SVO. There was a subset of investments that the SVO historically was unable to rate. Reasons might have included non-English or missing documentation, unavailability of or cost-prohibitive US GAAP-audited financials, or simply an investment type that was not large enough to elicit a SVO standard. These otherwise permissible investments had no assigned procedure for establishing NAIC designations. The 5*/6* process was put into place to handle these investments. This process was highly punitive for holders of the investments. They were penalized by NAIC 5 or NAIC 6 RBC charges. However, it allowed insurers to comply with NAIC guidelines by establishing NAIC designations on their investments.

This Principal and Interest Certification (5*/6*) process was established for all SVO investments unless specifically notated. It was approved, by the VOSTF, to be carried out by the SVO. It existed before the creation of the recently formed Structured Securities Group (SSG). Post-2009 revisions to SSAP 43R (Loan-Backed and Structured Securities) incorporated specific guidance for application of the SVO’s 5*/6* methodology. This was followed by a flow chart that provided additional instruction for SSAP 43R investments. ACLI has included the SSAP 43R flow chart with this submission. This has been highlighted to show the path of instructions that insurers would follow today to determine how to rate and report Loan-Backed and Structured Securities. The inclusion of this language clearly identifies that the 5*/6* process applies to all SSAP 43R Loan-Backed and Structured Securities. SSAP 43R has now been updated to refer to the Investment Analysis Office, instead of the SVO or SSG. SSAP 43R includes a much wider universe of investments that this proposal identifies in Part 3, Section 3 a) and b) of the Purposes and Procedures Manual.

Any divergence from this existing 5*/6* process should be approved by the VOSTF. There is a specific process for asking the VOSTF for placement of securities under regulatory review, when analytical instructions are insufficient or inadequate. This may be found in Part One, Section 2 f) of the Purposes and Procedures Manual.

We thank you for allowing us to comment on this memorandum and look forward to discussing this with you further.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy
23 April, 2015

Stewart Guerin
Chief Examiner
Louisiana Department of Insurance
Via email: sguerin@ldi.state.la.us


Dear Mr. Guerin,

In your capacity as chair of the NAIC’s Valuation of Securities Task Force (the “Task Force”) please accept these comments on the captioned proposal. These views are my own as an individual who has followed the work of this Task Force for more than a score of years.

Because of the timing it is quite clear that this proposal is linked to the issue of what staff is calling non-recourse notes in its memorandum of February 26, 2015. This memorandum concludes that these are not qualified to be admitted assets. Not only do I not agree with that conclusion, for reasons I describe in a comment letter on that document, but I believe the captioned memorandum is out of order and should be replaced by a request for a Regulatory Review as called for in the Manual.

The staff proposal essentially is to rewrite the Manual. In actuality what staff is required to do in instances of ambiguity is to submit a request for Regulatory Review. Whereas the Task Force is empowered to act as it sees fit, the staff does not have that discretion and it is required to follow the instructions of the Task Force as specified in the Manual. In this instance the Manual calls for a Regulatory Review.

I see nothing prohibiting staff from proposing a discussion of changes to the Manual at any time, but this particular proposal would preempt the required Regulatory Review and therefore it is out of order.

The very sequence of events makes it clear that staff lacked adequate instructions concerning what it calls non-recourse notes and which I will more accurately call socially responsible investments in affordable housing (SRIAHS):
Mid-December, 2014
- SVO decides to cease ratings of some SRIAHs, some of which it had rated for the better part of a decade
- Insurer(s) request for 5* Designations for the SRIAH(s) for which ratings have been withdrawn
- SVO/SSG conclude they have the authority to deny the request for 5* Designations and they do so. Had they concluded that they lacked this authority they would have been required to have initiated the Regulatory Review process, notifying the Task Force in writing.

Mid-January, 2015
- Staff submits to the Task Force the captioned proposal to redefine structured securities so as to specifically exclude some securities from eligibility for 5* 6* status. It still does not initiate the Regulatory Review Process.

It is clear then that the proper course of action is for staff to prepare a request for Regulatory Review.

Aside from the very important procedural matters there are significant substantive issues with this proposal. Staff characterizes this as a mere definition of terms but it has the effect of revoking a long-standing Task Force Rule that provides transparent and certain regulatory treatment for some non-rated securities that the NAIC itself is unable to rate. You will note that the proposal focuses not on achieving the objectives of this Task Force or NAIC, it does not assert that there are issues with the present Rule, and it does not propose any procedures to be put into place to replace the procedures it advocates eliminating. Instead the proposal takes great pains to divine “Regulator Intent” from as long as 20 years ago in order propose eliminating the existing treatment and replacing it with no guidance at all.

This proposal does not describe how its adoption would be an improvement to the current processes rather than being detrimental to them. For that, and the reasons that follow, I believe the proposal should not be adopted and that a Regulatory Review should commence.

What any proposal could do is to succinctly describe what problems there might be with the existing procedures that should be discussed by the Task Force. It could describe what the effect would be of changing this definition. It could discuss alternatives to eliminating the procedures for these securities. It could explicitly state what would become of the securities the change would affect. Instead, in a thicket of legal-sounding precedents and arcane language, it focuses on history rather than providing justifications for eliminating the procedures for the regulation of these assets.

In the balance of this letter I will discuss why the proposed change is not necessary. Even so I do not want to lose sight of the fact that the proposal simply excludes assets from a well-established transparent and orderly process without replacing that process that this Task Force instituted.
The Present Process

In this context there are four types of securities. The vast majority of securities owned by US insurers are rated by over two thousand credit analysts at rating agencies regulated by the U.S. Securities and Exchange Commission and recognized by the NAIC. The Task Force has instructed staff to use these ratings in its reporting and to make the source of these ratings transparent by affix a suffix of “FE” to the Designations.

The Designations for many fewer securities (RMBS and CMBS) are determined by two third-party contract vendors also according to instructions provided by the Task Force.

Even fewer securities are rated by approximately two dozen NAIC analysts according to the instructions provided to them in the form of the Task Force’s Purposes and Procedures Manual.

The group that would be affected by this proposal is probably the smallest group of all. These are securities for which NAIC-authorized third parties have not developed the basis for Designations, and the NAIC staff itself cannot develop Designations. This is because sufficient information is not available to conduct credit analyses. For many years the Task Force has directed that its 5* 6* Rule be applied to deal with this group of securities.

So the 5* 6* Rule developed by this Task Force deals with SSAP 26 and SSAP 43-R assets that the NAIC itself cannot rate. This Rule is completely transparent in its specifications and its effect.

Specifically, these assets that the NAIC cannot rate are automatically assigned what can only be thought of as a penalty factor because they are treated exactly the same as defaulted bonds, or NAIC 6. The Task Force allows an exception to this when an insurer attests, in addition to other characteristics, that the asset is meeting its obligations and is expected to continue to do so. In these cases the asset is assigned the next-to-lowest Designation, which is Designation 5. In the application of the 5* 6* Rule an asterisk is appended to these Designations for the sake of clarity and transparency to indicate that the NAIC has not evaluated these assets.

The Effect of this Proposal

If this proposal is enacted it will exempt certain securities from the existing 5* 6* Rule and create a fifth group of securities for which there is no method for establishing Designations. At the March 29th meeting of the Task Force the NAIC’s Julie Gann responded to a question by saying that the NAIC Designation does not affect where the asset is reported on the Statement and if a bond is a bond it is to be reported on Schedule D. But if the Task Force adopts this proposal and does not provide an alternative method for deriving Designations then insurers will be in a quandary with bonds for which the NAIC will not provide Designations but that still must be reported on Schedule D.

Conclusion

It is clear from this proposal that staff considers that the current instructions of the Task Force are insufficient or inadequate or otherwise there would be no proposal. This lack of clarity triggers an automatic Regulatory Review. In addition there is, and for many years there has been, an orderly process for arriving at NAIC Designations that are acceptable and transparent. Insurers bear a significant penalty for their very limited 5* and 6* holdings, but they have found that to be acceptable. Even as the effect of this proposal is to disrupt the long-standing process...
and replace it with no process at all it presents no justification for doing this. There is no argument that the proposal will advance the interests of this Task Force, the NAIC or state insurance regulators and there is no discussion of the negative effects that would result. While the Task Force may decide it should reexamine the 5* 6* Rule at some time, clearly this proposal should be rejected and be replaced by a request for Regulatory Review which is what the Manual requires of staff.
STRUCTURED SECURITIES (SSAP No. 43R) FLOW CHART

Does the security meet the definition of 43R?  

Yes

Are these securities considered "Exempt Obligations" for purposes of determining AVR and RBC?  

Yes

Follow instructions for modeled securities

No

Is the security modeled?  

Yes

Follow instructions for modified FE

No

Go to C

Is this security an Equipment Trust Certificate, Credit Tenant Lease, IO or rated by the SVO?  

No

Do this security have a designation assigned by the SVO?  

Yes

Use the SVO assigned designation

No

Is this security rated by an ARO?  

No

Convert ARO rating into NAIC designation in accordance with Part Two, Section 4(d), (i) of the SVO P&P Manual

Yes

Use this designation with an FE suffix

Is this security a new purchase? (120 day rule)  

No

Apply the 5*/6* Rule in accordance with Part Two, Section 5(f)-(g) of the SVO P&P Manual

Yes

Use Insurance Company’s internal rating with a Z Suffix
SECURITIES SUBJECT TO MODIFIED FILING EXEMPT PROCESS

- **Yes**: Convert ARO rating into NAIC designation in accordance with Part Two, Section 4(d), (i) of the SVO P&P Manual.

  - **Yes**: Report the NAIC 1 using amortized cost as B./A.C.V. with FE suffix. Report the NAIC 6 using lower of amortized cost or fair value as B./A.C.V. with FE suffix.

  - **Yes**: Determine lower of amortized cost or fair value. Is the amount amortized cost?
    - **Yes**: Report as Final designation using amortized cost as B./A.C.V. with AM suffix.
    - **No**: Report as Final designation using amortized cost as B./A.C.V. with AM suffix.

- **No**: Is the converted rating a 1 or a 6?
  - **Yes**: Using the converted ARO rating (2-5), apply amortized cost to the MFE pricing matrix to obtain the initial designation.
    - **Yes**: Do you maintain an AVR?
      - **Yes**: Is the initial designation a 1-5?
        - **Yes**: Report as Final designation using amortized cost as B./A.C.V. with AM suffix.
        - **No**: Determine lower of amortized cost or fair value. Is the amount amortized cost?
          - **Yes**: Report as Final designation using amortized cost as B./A.C.V. with AM suffix.
          - **No**: Using the converted ARO rating (2-5), apply fair value to MFE pricing matrix to determine Final NAIC Designation.

  - **No**: Using the converted ARO rating (2-5), apply internal rating with a Z suffix.
    - **No**: Apply the 5*/6* Rule in accordance with Part Two, Section 5(f)-(g) of the SVO P&P Manual.

  - **No**: Is this security a new purchase? (120 day rule)
    - **Yes**: Use Insurance Company's internal rating with a Z Suffix.

- **No**: Is this security rated by an ARO?
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office
CC: Charles Therriault, NAIC Director, Securities Valuation Office
    Eric Kolchinsky, NAIC Director, Structured Securities Group
    Edward Toy, NAIC Director, Capital Markets Bureau
    Todd Sells, NAIC Director, Financial Regulatory Services

DATE: October 2, 2014
RE: Referral from the Financial Condition (E) Committee Requesting a Review of the NAIC Derivative Instruments Model Regulation

1. Introduction – The Financial Condition (E) Committee has requested that the Task Force review the Derivatives Instruments Model Regulation (#282) (“Model #282”) and opine whether it should be retained as a model law, amended, converted to a guideline or archived. The request was referred to the Financial Condition (E) Committee by the Executive (EX) Committee, which is conducting a Model Law Review Initiative under the NAIC’s Procedures for Model Law Development (“Procedures”). The Procedures require NAIC members to affirmatively support adopted NAIC model laws. To identify those adopted models that NAIC members may no longer want to support, the Procedures provide for a review of the rates of adoption and an assessment whether the rates imply a consensus that the subject of the model requires a minimum national standard or uniformity among the states and a commitment by NAIC members to devote the resources necessary to support the model (the “Review”).

2. A Threshold Issue – Since its most recent revision and re-adoption by the NAIC in 2009, one state has adopted Model #282. Nine other states have adopted some other related legislation, which could be an older version of the NAIC model or

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1 In support of the Review, the NAIC Legal Division performs a preliminary review to identify model laws that should be reviewed in the coming year. The model laws are selected because they were: 1) adopted and/or amended after the 2007 Model Law criteria became effective; 2) are not associated with an accreditation standard; and 3) are not associated with a federal law directive.

2 Implementation of the Model Law “Upon NAIC adoption of the Model Law, it will be a priority of the NAIC, through the collective efforts of the Members, to uniformly adopt the Model Law in a majority of states within three years after its adoption by the NAIC membership. The NAIC Members will devote significant regulator and NAIC resources to communicate, educate and support the Model Law. The NAIC staff will provide briefing materials, testimony, make state visits and answer questions. The Executive Committee shall provide updates to the NAIC Plenary on the status of adoption by states of the Model Law.” From Procedures for Model Law Development, adopted May 2007 and amended September 2008 and July 2013.

3 Review of Existing Model Laws The Executive (EX) Committee may undertake a review of the adoption rates of existing Model Laws. If the Executive (EX) Committee determines the existing Model Law does not meet the criteria, it shall be reclassified as a Guideline as defined above. If the Executive (EX) Committee determines the existing Model Law meets the criteria, it will be made a priority of the NAIC to pursue uniform adoption in the remaining states.

4 Model Law Development Criteria The Executive (EX) Committee of the NAIC, upon a recommendation of the Parent Committee, will determine if a proposed new Model Law (or Regulation) or amendment to an existing Model Law (or Regulation) meets a two-pronged test (Model Law Development Criteria) as follows: 1) the issue that is the subject of the Model Law necessitates a minimum national standard and/or requires uniformity amongst all states; and 2) where NAIC Members are committed to devoting significant regulator and association resources to educate, communicate and support a model that has been adopted by the membership. From Procedures for Model Law Development, adopted May 2007 and amended September 2008 and July 2013.
SECURITIES SUBJECT TO MODIFIED FILING EXEMPT PROCESS

Is this security rated by an ARO?

Yes

Convert ARO rating into NAIC designation in accordance with Part Two, Section 4(d), (i) of the SVO P&P Manual

No

Is this security a new purchase? (120 day rule)

Yes

Apply the 5*/6* Rule in accordance with Part Two, Section 5(f)-(g) of the SVO P&P Manual

No

Use Insurance Company’s internal rating with a Z Suffix

Is the converted rating a 1 or a 6?

Yes

Report the NAIC 1 using amortized cost as B./A.C.V. with FE suffix. Report the NAIC 6 using lower of amortized cost or fair value as B./A.C.V. with FE suffix

No

Using the converted ARO rating (2-5), apply amortized cost to the MFE pricing matrix to obtain the initial designation

Do you maintain an AVR?

Yes

Is the initial designation a 1-5?

No

Is the initial designation a 1 or 2?

Yes

Determine lower of amortized cost or fair value. Is the amount amortized cost?

No

Report as Final designation using amortized cost as B./A.C.V. with AM Suffix

Yes

Using the converted ARO rating (2-5), apply fair value to MFE pricing matrix to determine Final NAIC Designation

Report final designation using fair value as B./A.C.V. with AM suffix

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legislation or regulation derived from other sources.\(^5\) The threshold issue before the Task Force is whether the Review is intended to be a mechanistic assessment of rates. If so, the above information would indicate that NAIC members do not see a need for a national or a uniform derivatives standard and are not willing to support Model #282. However, a referral to the Task Force would not have been necessary if the Procedures contemplated that the Review would be a purely mechanical assessment as such an assessment could have been performed by NAIC staff.

3. **Background** - The Task Force conducted a review of Model #282 beginning in 2006 before the Procedures had been adopted. It completed the review in 2007 as the Procedures were being phased in and implemented changes to NAIC guidance in 2009, after the Procedures had been adopted. In 2005 and 2006, the Task Force noted that although the rate of adoption of Model #282 itself was low (four states), 19 states had adopted one or both of the derivatives section of the *Investments of Insurers Model Act (Defined Limits Version)* (Model #280) of which Model #282 was companion legislation. More importantly, the Task Force focused on the nature of the derivatives industry and instruments and concluded that the subject matter required a national standard irrespective of state rates of adoption.\(^6\) Accordingly, the Task Force formed the Derivative Market Study (E) Working Group and charged it with conducting a study of changes in the derivatives market and of insurer’s use of derivatives. The study led to a significant streamlining and revision of the reporting schedules to obtain more meaningful information about insurer derivative activity. It also led to referrals to other NAIC groups to modify other regulatory guidance for derivatives, which resulted in revisions to Model #282 and a recommendation that the NAIC retain it as a national standard.\(^7\)

4. **Recommendation** – The financial landscape has been significantly altered since the Task Force concluded its review of Model #282 in 2007. The SVO and Structured Securities Group (SSG) recommend that the Task Force undertake an evaluation of changes in federal laws and regulation governing derivatives, current insurer uses of derivatives and changes in the derivatives marketplace. This evaluation could be implemented in a series of public meetings supported by staff research and staffed by legal and derivatives industry experts, federal regulators and insurance company investment professionals supporting and knowledgeable about insurer derivatives activity. The result of staff research and the information gathered at the meetings could then be used to evaluate whether changes are needed to existing NAIC guidance on derivatives, including, but not limited to, statutory accounting and reporting instructions. In turn, these considerations would provide a holistic perspective from which the Task Force could determine how best to respond to the Financial Condition (E) Committee.

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\(^5\) The 2013 Model Review Criteria Worksheet for Model #282 created by the NAIC Legal Department indicates one state adopted the 2009 version. The new as part of the current Review. The Model Regulation Service as of April 2012 identifies the states that have the same or related activity. Please see Attachment Eight-A.

\(^6\) To: Jeffrey C. Johnston, Director, Financial Regulatory Services – NAIC; Todd Sells, Senior Financial Regulatory Services Manager - NAIC, Leslie Geel, Financial Research Manager

From: Michael Moriarty, Chair of the Valuation of Securities Task Force; Bob Carcano, Senior Counsel, SVO - NAIC

Re: Model Regulation 282 — Derivatives Model Law — Referral from NAIC Staff

Date: November 18, 2005

"... The senior staff has asked the Task Force to review the staff recommendation and to provide any comments and/or revisions the Task Force deemed appropriate. The Task Force considered the staff recommendation and discussed it in two interim meeting conference calls held on August 18 and October 4. It is the sense of the Task Force that it would be inappropriate to delete Model Regulation 282 without first assessing whether developments in the derivatives marketplace require changes in regulation. However, a study of developments in the derivatives market would require a significant commitment of time and resources. Accordingly, the Task Force has agreed to direct a study of the derivatives marketplace as a 2006 project and has instructed the SVO to research current regulation and to provide feedback to the Task Force early next year. During the discussions held on Model Regulation 282, interested persons questioned whether enough states had adopted the Model Regulation to warrant the dedication of time and resources that a thorough review of the derivatives markets would require. While the SVO found that only four states (CA, CT, IL and NY) have adopted Model Regulation 282, 19 states have adopted one or both of the derivatives section of the Investment of Insurers Model Act (Defined Limits Version). We concluded that this was a better indicator of regulatory interest in an updated understanding of the derivatives marketplace." NAIC Proceedings 2005 4th Qt at page 2065, 2128 - Attachment Fourteen, Valuation of Securities (E) Task Force meeting of 12/4/05.

\(^7\) The activity of the Task Force and of the Working Group are documented in the following NAIC Proceedings:

2005 – 2nd Quarter (Q); 3rd Qt at page 543; 4th Qt at page 2065

2006 – 3rd Qt at page 1581; 4th Qt at page 1902

2007 - 1st Qt at page 1243; 2nd Qt at page 1045; 3rd Qt at page 1323; 4th Qt at page 10-616

2008 - 2nd Qt at page 10-625; 3rd Qt at page 10-742; 4th Qt at page 10-717

2009 - 1st Qt at page 10-562.

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DERIVATIVE INSTRUMENTS MODEL REGULATION

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Section 1. Authority
Section 2. Purpose
Section 3. Definitions
Section 4. Guidelines and Internal Control Procedures
Section 5. Commissioner Approval
Section 6. Documentation Requirements
Section 7. Trading Requirements
Section 8. Effective Date

Section 1. Authority

This regulation is adopted and promulgated by the Commissioner of Insurance pursuant to [insert citation to state law equivalent to Section 8 of the Investments of Insurers Model Act].

Section 2. Purpose

The purpose of this regulation is to set standards for the prudent use of derivative instruments in accordance with [insert citation to state law equivalent to Section 9 and 18 of the Investments of Insurers Model Act].

Section 3. Definitions

For the purposes of this regulation, the following definitions shall apply:

A. “Business entity” includes a sole proprietorship, corporation, limited liability company, association, partnership, joint stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether for-profit or not-for-profit.

B. “Counterparty exposure amount” means:

(1) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse (“over-the-counter derivative instrument”). The amount of credit risk equals:

(a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurance company; or

(b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurance company.

(2) If over-the-counter derivative instruments are entered into pursuant to a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities
Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

(a) The market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment to the insurance company; and

(b) The market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment by the insurance company to the business entity.

(3) For open transactions, market value shall be determined at the end of the most recent quarter of the insurance company's fiscal year and shall be reduced by the market value of acceptable collateral held by the insurance company or placed in escrow by one or both parties.

C. (1) “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:

(a) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

(b) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

(2) Derivative instruments include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof. Derivative instruments shall additionally include any agreements, options or instruments permitted under regulations adopted pursuant to [insert citation to state law equivalent to Section 8 of the Investments of Insurers Model Act]. Derivative instruments shall not include an investment authorized by [insert state law equivalent to Sections 11 through 17, 19 and 24 through 30 of the Investments of Insurers Model Act].

D. “Qualified clearinghouse” means a clearinghouse for, and subject to the rules of a qualified exchange or a qualified foreign exchange, which clearinghouse provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.

E. “Qualified exchange” means:

(1) A securities exchange registered as a national securities exchange, or a securities market regulated under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78 et seq.), as amended;

(2) A board of trade or commodities exchange designated as a contract market by the Commodity Futures Trading Commission or any successor thereof;
F. “Qualified foreign exchange” means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions:

1. That has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s Regulations, 17 C.F.R. Part 30);

2. That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s Regulations, 17 C.F.R. Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or

3. Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC’s Office of General Counsel, but an exchange, board of trade or contract market that qualifies as a “qualified foreign exchange” only under this paragraph shall only be a “qualified foreign exchange” as to foreign stock index futures contracts that are the subject of such no-action relief under this paragraph.

Section 4. Guidelines and Internal Control Procedures

A. Before engaging in a derivative transaction, an insurance company shall establish written guidelines, approved by the Commissioner, that shall be used for effecting and maintaining derivative transactions. The guidelines shall:

1. Specify insurance company objectives for engaging in derivative transactions and derivative strategies and all applicable risk constraints, including credit risk limits;

2. Establish counterparty exposure limits and credit quality standards

3. Identify permissible derivative transactions and the relationship of those transactions to insurance company operations; for example, a precise identification of the risks being hedged by a derivative transaction; and

4. Require compliance with internal control procedures.

B. An insurance company shall have a written methodology for determining whether a derivative instrument used for hedging has been effective.
C. An insurance company shall have written policies and procedures describing the credit risk management process and a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

D. An insurance company's board of directors shall, in accordance with [insert citation to state law equivalent of Section 4 of the Investments of Insurers Model Act]:

1. Approve the written guidelines, methodology and policies and procedures required by Subsection A, B and C respectively, of this section and the systems required by Subsections B and C of this section; and

2. Determine whether the insurance company has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.

3. Review whether derivatives transactions have been made in accordance with the approved guidelines and consistent with stated objectives.

4. Take action to correct any deficiencies in internal controls relative to derivative transactions.

Section 5. Commissioner Approval

Written documentation explaining the insurance company's internal guidelines and controls governing derivative transactions shall be submitted for approval to the Commissioner. The Commissioner shall have the authority to disapprove the guidelines and controls proposed by the company if the insurance company cannot demonstrate the proposed internal guidelines and controls would be adequate to manage the risks associated with the derivative transactions the insurance company intends to engage in.

Section 6. Documentation Requirements

An insurance company shall maintain documentation and records relating to each derivative transaction, such as:

A. The purpose or purposes of the transaction;

B. The assets or liabilities to which the transaction relates;

C. The specific derivative instrument used in the transaction;

D. For over-the-counter derivative instrument transactions, the name of the counterparty and the market value; and

E. For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade and the market value.
Section 7. Trading Requirements

Each derivative instrument shall be:

A. Traded on a qualified exchange;
B. Entered into with, or guaranteed by, a business entity;
C. Issued or written with the issuer of the underlying interest on which the derivative instrument is based; or
D. Entered into with a qualified foreign exchange.

Section 8. Effective Date

This regulation shall become effective [insert date].

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

2009 Proc. 2nd Quarter (amended and reprinted).
DERIVATIVE INSTRUMENTS MODEL REGULATION

These charts are intended to provide the readers with additional information to more easily access state statutes, regulations, bulletins or administrative rulings which are related to the NAIC model. Such guidance provides the reader with a starting point from which they may review how each state has addressed the model and the topic being covered. The NAIC Legal Division has reviewed each state’s activity in this area and has made an interpretation of adoption or related state activity based on the definitions listed below. The NAIC’s interpretation may or may not be shared by the individual states or by interested readers.

This state page does not constitute a formal legal opinion by the NAIC staff on the provisions of state law and should not be relied upon as such. Every effort has been made to provide correct and accurate summaries to assist the reader in targeting useful information. For further details, the laws cited should be consulted. The NAIC attempts to provide current information; however, due to the timing of our publication production, the information provided may not reflect the most up to date status. Therefore, readers should consult state law for additional adoptions and subsequent bill status.
DERIVATIVE INSTRUMENTS MODEL REGULATION

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**DERIVATIVE INSTRUMENTS MODEL REGULATION**

**KEY:**

**MODEL ADOPTION:** States that have citations identified in this column adopted the most recent version of the NAIC model in a **substantially similar manner**. This requires states to adopt the model in its entirety but does allow for variations in style and format. States that have adopted portions of the current NAIC model will be included in this column with an explanatory note.

**RELATED STATE ACTIVITY:** States that have citations identified in this column have **not** adopted the most recent version of the NAIC model in a substantially similar manner. Examples of Related State Activity include but are not limited to: An older version of the NAIC model, legislation or regulation derived from other sources such as Bulletins and Administrative Rulings.

**NO CURRENT ACTIVITY:** No state activity on the topic as of the date of the most recent update. This includes states that have repealed legislation as well as states that have never adopted legislation.

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MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, NAIC Director, Securities Valuation Office
    Eric Kolchinsky, NAIC Director, Structured Securities Group
    Edward Toy, NAIC Director, Capital Markets Bureau
    Todd Sells, NAIC Director, Financial Regulatory Services

DATE: May 26, 2015

RE: Staff Report - Review of Derivatives Sections of the NAIC Investments of Insurers Model Act (Defined Limits Version) (# 280) (the “Model Act”) and the NAIC Derivative Instruments Model Regulation (# 282) (the “Model Regulation”)

1. Introduction – This memorandum presents the results of a comparison of the laws of states with significant insurer exposure to derivatives with the derivatives provisions in the Model Act and Model Regulation. Attachment One identifies states whose laws we reviewed; in the order of insurer derivative exposure (highest to lowest) showing whether the laws of the state follow the standards in the NAIC Model Act and Model Regulation. Attachment Two shows the chart, created by the NAIC Capital Markets Bureau for a research report, from which the staff derived the state listing. Attachment Three is a compilation of the state law provisions found by NAIC Legal that discuss derivatives. The determinations shown in Attachment One were made using criteria derived from the Model Act and Model Regulation. The criterion used is shown in the state specific results that follow each state law compilation.

2. Objective and Conclusions – Thirteen states held 96.01% of insurer derivatives exposure on a BACV basis. The staff recommends that the Task Force consider whether, as a policy matter, it is appropriate to consider this population as the appropriate benchmark to decide whether the Model Regulation should be considered a national standard. In making our determinations we assigned a numerical value of 100 when state laws reflected both the Model Act and Model Regulation. We assigned a numerical value of 50 when a state’s laws only reflected the Model Act or Regulation – but not both. A numerical value of 0 (zero) was assigned when a state’s law did not reflect either the Model Act or the Model Regulation. We awarded some portion of the numerical value of 50 when a state’s law contained core provisions of the Model Act or Model Regulation but not the detail in the Models. We found:

- 7 states have and 6 have not adopted the Model Act - a total adoption rate of 50.00%.
- 8 states have and 5 have not adopted the Model Regulation - a total adoption rate of 61.54%.
- BACV weighted - 51.07% states have adopted the Model Act and 70.81% have adopted the Model Regulation - an average adoption rate of 60.94%.

1 A comparison of the derivative provisions in the Model Act that apply to Life and P&P Companies shows the provisions are almost identical. The only difference we observed is that Section 31 does not discuss or provide authority for generating cash flows for payments under caps or floors in paragraph C the heading of which is: Limitations on Income Generation Transactions.
### Attachment One

**Summary Comparison of NAIC Models to Selected State Laws**

U.S. Insurance Industry Derivatives Exposure Ranked by State - YE2013 (SBACV)

<table>
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<tr>
<th>State</th>
<th>BACV</th>
<th>%</th>
<th>Rank</th>
<th>Assessment of the Investment Analysis Office</th>
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<td>New York</td>
<td>$303,408,247,061</td>
<td>16.36%</td>
<td>1</td>
<td>Yes, follows standards in Act with some minor differences</td>
<td>100%</td>
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<td>Connecticut</td>
<td>$292,249,356,898</td>
<td>15.75%</td>
<td>2</td>
<td>Yes, follows standards in Regulation with some minor differences</td>
<td>100%</td>
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<td>Michigan</td>
<td>$239,440,229,057</td>
<td>12.91%</td>
<td>3</td>
<td>No, The statute contains key concepts found in the Act but none of the detail</td>
<td>50%</td>
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<td>Massachusetts</td>
<td>$206,607,200,394</td>
<td>11.14%</td>
<td>4</td>
<td>No, No statutory text following the Act was found</td>
<td>0%</td>
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<td>Minnesota</td>
<td>$152,752,989,946</td>
<td>8.23%</td>
<td>5</td>
<td>No, Adopted NAIC Defined Standard Version of Investment of Insurers Model Act</td>
<td>0%</td>
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<tr>
<td>Iowa</td>
<td>$149,950,553,994</td>
<td>8.08%</td>
<td>6</td>
<td>No, Does not follow NAIC standards in Act</td>
<td>50%</td>
</tr>
<tr>
<td>Delaware</td>
<td>$116,609,821,006</td>
<td>6.29%</td>
<td>7</td>
<td>Yes, follows standards in the Regulation with some minor differences</td>
<td>100%</td>
</tr>
<tr>
<td>Ohio</td>
<td>$78,608,164,037</td>
<td>4.24%</td>
<td>8</td>
<td>Yes-Qualified (50%), follows some of the standards in the Act</td>
<td>75%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>$67,246,233,569</td>
<td>3.63%</td>
<td>9</td>
<td>No, No statutory text following the Act was found</td>
<td>0%</td>
</tr>
<tr>
<td>Indiana</td>
<td>$64,742,764,733</td>
<td>3.49%</td>
<td>10</td>
<td>Yes, follows standards in Act with some minor differences</td>
<td>100%</td>
</tr>
<tr>
<td>Arizona</td>
<td>$57,270,663,864</td>
<td>3.09%</td>
<td>11</td>
<td>Yes, follows standards in Act with some minor differences</td>
<td>50%</td>
</tr>
<tr>
<td>Nebraska</td>
<td>$35,946,505,542</td>
<td>1.94%</td>
<td>12</td>
<td>Yes, follows standards in Act with some minor differences</td>
<td>50%</td>
</tr>
<tr>
<td>Texas</td>
<td>$15,957,721,606</td>
<td>0.86%</td>
<td>13</td>
<td>No, Does not follow standards in Act with some minor differences</td>
<td>50%</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$1,780,790,451,707</strong></td>
<td><strong>96.01%</strong></td>
<td></td>
<td><strong>6.5-Yes / 6.5-No</strong></td>
<td><strong>50.00%</strong></td>
</tr>
<tr>
<td><strong>Yes - weighted by BACV %</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>51.07%</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>70.81%</strong></td>
</tr>
</tbody>
</table>

Note: Yes= 100%, No=0%, Qualified Yes=50% for Ohio.

Minnesota makes reference to NAIC reporting but did not adopt the Model Act nor Regulation.

BACV - Represents the statement value with any nonadmitted assets added back. Refer to SSAP No. 86, Accounting for Derivative Instruments... for further discussion.

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# Attachment Two

## Chart of States with Insurer Derivative Exposure


<table>
<thead>
<tr>
<th>State</th>
<th>Fraternal</th>
<th>Life</th>
<th>Property/Casualty</th>
<th>Health</th>
<th>Total</th>
<th>Pct of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>NY</td>
<td>301,780,439,401</td>
<td>1,627,807,660</td>
<td>-</td>
<td>-</td>
<td>303,408,247,061</td>
<td>16.36%</td>
</tr>
<tr>
<td>CT</td>
<td>201,129,073,678</td>
<td>91,120,285,220</td>
<td>-</td>
<td>-</td>
<td>292,249,358,898</td>
<td>15.75%</td>
</tr>
<tr>
<td>MI</td>
<td>239,441,479,057</td>
<td>-</td>
<td>1,250,000</td>
<td>239,441,249,057</td>
<td>239,441,229,057</td>
<td>12.91%</td>
</tr>
<tr>
<td>MA</td>
<td>265,484,654,631</td>
<td>33,545,763</td>
<td>-</td>
<td>-</td>
<td>265,484,654,631</td>
<td>11.14%</td>
</tr>
<tr>
<td>MN</td>
<td>152,752,889,915</td>
<td>-</td>
<td>31</td>
<td>-</td>
<td>152,752,889,946</td>
<td>8.33%</td>
</tr>
<tr>
<td>IA</td>
<td>149,811,865,121</td>
<td>138,888,879</td>
<td>-</td>
<td>-</td>
<td>149,811,865,121</td>
<td>8.08%</td>
</tr>
<tr>
<td>DE</td>
<td>101,973,644,068</td>
<td>14,356,176,998</td>
<td>-</td>
<td>-</td>
<td>116,329,821,066</td>
<td>6.29%</td>
</tr>
<tr>
<td>OH</td>
<td>75,861,540,069</td>
<td>2,746,523,977</td>
<td>-</td>
<td>-</td>
<td>78,608,064,047</td>
<td>4.24%</td>
</tr>
<tr>
<td>NJ</td>
<td>65,485,752,627</td>
<td>1,760,480,942</td>
<td>-</td>
<td>-</td>
<td>67,246,233,569</td>
<td>3.63%</td>
</tr>
<tr>
<td>IN</td>
<td>50,000,000</td>
<td>4,411,100</td>
<td>-</td>
<td>-</td>
<td>54,411,100</td>
<td>3.49%</td>
</tr>
<tr>
<td>AZ</td>
<td>57,258,863,715</td>
<td>149</td>
<td>11,800,000</td>
<td>-</td>
<td>57,270,663,864</td>
<td>3.09%</td>
</tr>
<tr>
<td>NE</td>
<td>3,415,000</td>
<td>35,943,090,542</td>
<td>-</td>
<td>-</td>
<td>35,943,090,542</td>
<td>1.94%</td>
</tr>
<tr>
<td>TX</td>
<td>15,957,720,622</td>
<td>984</td>
<td>-</td>
<td>-</td>
<td>15,957,721,606</td>
<td>0.86%</td>
</tr>
<tr>
<td>IL</td>
<td>14,096,395,137</td>
<td>414,185,600</td>
<td>-</td>
<td>-</td>
<td>14,510,580,737</td>
<td>0.78%</td>
</tr>
<tr>
<td>MO</td>
<td>10,323,634,429</td>
<td>8,751,993</td>
<td>-</td>
<td>-</td>
<td>19,075,628,422</td>
<td>1.06%</td>
</tr>
<tr>
<td>WI</td>
<td>117,126,551</td>
<td>1,236,600,000</td>
<td>-</td>
<td>-</td>
<td>118,362,751,551</td>
<td>0.51%</td>
</tr>
<tr>
<td>KS</td>
<td>8,903,018,594</td>
<td>206</td>
<td>-</td>
<td>-</td>
<td>8,903,018,790</td>
<td>0.48%</td>
</tr>
<tr>
<td>CO</td>
<td>8,119,938,725</td>
<td>-</td>
<td>70,400,000</td>
<td>-</td>
<td>8,190,338,725</td>
<td>0.45%</td>
</tr>
<tr>
<td>CA</td>
<td>7,153,472,336</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>7,153,472,336</td>
<td>0.39%</td>
</tr>
<tr>
<td>PA</td>
<td>4,813,063,289</td>
<td>227,684,225</td>
<td>-</td>
<td>-</td>
<td>5,040,747,514</td>
<td>0.25%</td>
</tr>
<tr>
<td>TN</td>
<td>4,723,584,610</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4,723,584,610</td>
<td>0.25%</td>
</tr>
<tr>
<td>VA</td>
<td>1,943,766,460</td>
<td>34,800,000</td>
<td>-</td>
<td>-</td>
<td>1,978,566,460</td>
<td>0.11%</td>
</tr>
<tr>
<td>AR</td>
<td>737,592,953</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>737,592,953</td>
<td>0.04%</td>
</tr>
<tr>
<td>FL</td>
<td>650,949,759</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>650,949,759</td>
<td>0.04%</td>
</tr>
<tr>
<td>VT</td>
<td>500,001,200</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>500,001,200</td>
<td>0.03%</td>
</tr>
<tr>
<td>OR</td>
<td>350,521,157</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>350,521,157</td>
<td>0.02%</td>
</tr>
<tr>
<td>ME</td>
<td>228,946,546</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>228,946,546</td>
<td>0.01%</td>
</tr>
<tr>
<td>NC</td>
<td>200,000,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>200,000,000</td>
<td>0.01%</td>
</tr>
<tr>
<td>WA</td>
<td>200,000,000</td>
<td>75,000,000</td>
<td>-</td>
<td>-</td>
<td>275,000,000</td>
<td>0.01%</td>
</tr>
<tr>
<td>UT</td>
<td>83,141,678</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>83,141,678</td>
<td>0.00%</td>
</tr>
<tr>
<td>SD</td>
<td>54,627,216</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>54,627,216</td>
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</tr>
<tr>
<td>RI</td>
<td>31,886,200</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>31,886,200</td>
<td>0.00%</td>
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<tr>
<td>GA</td>
<td>27,000,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>27,000,000</td>
<td>0.00%</td>
</tr>
<tr>
<td>SC</td>
<td>5,000,000</td>
<td>16,959,615</td>
<td>-</td>
<td>-</td>
<td>21,959,615</td>
<td>0.00%</td>
</tr>
<tr>
<td>LA</td>
<td>4,020,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4,020,000</td>
<td>0.00%</td>
</tr>
<tr>
<td>HI</td>
<td>3,877,938</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3,877,938</td>
<td>0.00%</td>
</tr>
<tr>
<td>AL</td>
<td>1,851,960</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1,851,960</td>
<td>0.00%</td>
</tr>
<tr>
<td>KY</td>
<td>89,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>89,000</td>
<td>0.00%</td>
</tr>
<tr>
<td>NH</td>
<td>70,500</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>70,500</td>
<td>0.00%</td>
</tr>
<tr>
<td>MS</td>
<td>62,036</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>62,036</td>
<td>0.00%</td>
</tr>
<tr>
<td>ID</td>
<td>37</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>37</td>
<td>0.00%</td>
</tr>
<tr>
<td>OK</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1</td>
<td>0.00%</td>
</tr>
</tbody>
</table>

**Total** | 1,854,994,471,298 | 100.00%
1. New York

McKinney’s Insurance Law § 1410

§ 1410. Derivative transactions and derivative instruments

(a) For purposes of this section, except subsection (k) of this section, an insurer shall mean a domestic life insurer, a domestic property/casualty insurer...

(b) (1) An insurer may only engage in derivative transactions pursuant to and in compliance with … this section. Any insurer subject to the provisions of subsection (c) of section one thousand four hundred three … shall also comply with the requirements … in such subsection relative to derivative transactions authorized by this section. (2) An insurer may use derivative instruments under this section to engage in hedging transactions, replication transactions, and for certain limited income generation transactions authorized pursuant to this section.

3) Prior to entering into any derivative transaction authorized pursuant to this section: (A) the board of directors of the insurer or a committee thereof charged … shall: (i) authorize such transactions, (ii) assure that all individuals conducting, monitoring, controlling and auditing derivative transactions are suitably qualified and have appropriate levels of knowledge and experience, and (iii) approve a derivative use plan for such transactions or an amendment…

(B) the insurer shall submit a written derivative use plan or amendment thereto to the superintendent for approval; and (C) the superintendent shall approve the insurer’s written derivative plan for engaging in derivative transactions and investment practices related to derivative transactions. The plan shall specify guidelines as to the quality, maturity and diversification of derivative investments and other specifications, including investment strategies, asset/liability management practices, its liquidity needs and its capital and surplus as they relate to the derivative use plan. The board of directors or a committee thereof charged with the responsibility for supervising investments shall determine at least quarterly whether all derivative transactions have been made in accordance with delegations, standards, limitations and investment objectives prescribed in the insurer’s derivatives use plan… (D) (i) Within ninety days of receipt of a derivative use plan application, the superintendent shall, in writing, approve, submit a detailed list to the insurer requesting all additional information necessary to make a determination on the plan, or deny such plan; otherwise, such plan shall be deemed approved. Any denial … shall state the reasons for such disapproval …

(4) An insurer which engages in hedging transactions or replication transactions as authorized pursuant to this section shall: (A) only maintain its position in any outstanding derivative instrument used as part of a hedging transaction or replication transaction as long as the hedging transaction or replication transaction, as the case may be, continues to be effective; and (B) be able to demonstrate to the superintendent, upon request, that any derivative transaction entered into and involving a hedging transaction or replication transaction, at the point of inception is and, for as long as the derivative transaction remains outstanding, continues to be, an effective hedging or replication transaction.

(5) An insurer which enters into derivative transactions as authorized pursuant to this section shall be required to include, as part of the evaluation of accounting procedures and internal controls required to be filed … a statement describing the assessment by the independent certified public accountant of the internal controls relative to derivative transactions. If the internal controls … are determined to be deficient, the insurer shall require the accountant to include in the evaluation a description of such deficiencies and the insurer shall append to the evaluation a description of any remedial actions taken or proposed to be taken to correct these deficiencies, if such actions are not already described in the accountant’s report.

(c)(1) An insurer may enter into hedging transactions pursuant to this section if, as a result of and after giving effect to the transaction: (A) the aggregate statement value of options, swaptions, caps, floors and warrants purchased pursuant to this section does not exceed seven and one-half percent of its admitted assets; (B) the aggregate statement of value of options, swaptions, caps and floors written pursuant to this section does not exceed three percent of its admitted assets; and (C) the aggregate potential exposure of collars, swaps, forwards and futures entered into and options, swaptions, caps and floors written pursuant to this section does not exceed six and one-half percent of its admitted assets…

(d) An insurer may enter into income generation transactions under this section only through the sale of call options on
An insurer may purchase or sell one or more derivative instruments to offset any derivative instrument previously purchased or sold, as the case may be, without regard to the quantitative limitations of subsection (c) of this section provided that such derivative instrument is an exact offset to the original derivative instrument being offset. (f)(1) The counterparty exposure under an over the counter derivative instrument entered into by an insurer authorized to engage in transactions pursuant to this section shall be deemed to be an obligation of the institution to which the insurer is exposed to credit risk and shall be included in determining compliance with any single or aggregate quantitative limitation on investments made by an insurer under this chapter. (2) Notwithstanding any single or aggregate quantitative limitation on investments made by an insurer under this chapter, an insurer may only transact an over the counter derivative instrument with: (A) a “qualified counterparty” if, after giving effect to that transaction, the aggregate counterparty exposure of the insurer under one or more over the counter derivative instruments to: (i) that non-qualified counterparty; or (B) a counterparty other than a “qualified counterparty” if, after giving effect to that transaction, the aggregate counterparty exposure of the insurer under one or more over the counter derivative instruments to: (i) that non-qualified counterparty does not exceed one percent of the insurer’s admitted assets; and (ii) all counterparties, other than qualified counterparties, does not exceed three percent of the insurer’s admitted assets.

(3) For purposes of this section:
(A) a “qualified counterparty” is a counterparty which has an investment grade rating from at least one nationally recognized statistical rating organization or a designation of one from the Securities Valuation Office of the National Association of Insurance Commissioners, or any successor office established by the National Association of Insurance Commissioners, and with which the insurer has entered into a master agreement, together with a credit support annex or other documentation providing for the collateralization of the counterparty’s obligations to the insurer under the master agreement, if that collateral documentation provides for (i) daily margin and collateral settlement, in cash or investment grade securities, between the parties, (ii) a minimum transfer amount of no more than one million dollars, and (iii) a requirement that collateral be provided by the counterparty from the first dollar of exposure, subject to the minimum transfer amount; (B) “aggregate counterparty exposure” means the sum of: (i) the aggregate statement value of options, swaptions, caps, floors, and warrants purchased; and (ii) the aggregate potential exposure of collars, swaps, forwards and futures entered into; (C) “over the counter derivative instrument” means a derivative instrument which is authorized under this chapter other than a derivative instrument (i) cleared through a United States or foreign derivatives clearinghouse, or (ii) traded on or through a United States or foreign exchange providing derivatives clearing services; (D) “derivatives clearinghouse” means a derivatives clearing organization registered with the Commodity Futures Trading Commission or the Securities and Exchange Commission or, if not so registered, is a foreign clearinghouse regulated, supervised and examined by a regulatory authority in a foreign jurisdiction approved by the superintendent; (E) “master agreement” means a written master agreement relating to derivatives transactions that provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a jurisdiction approved by the superintendent as eligible for netting; and …

(h) The superintendent shall promulgate regulations to: (1) define terms used in this section that are not otherwise defined; (2) establish the content of the derivative use plan to be submitted by an insurer to the superintendent pursuant to this section; (3) establish effective management oversight standards, including quarterly reporting to the board of directors or a committee thereof charged with the responsibility for supervising investments, for transactions authorized pursuant to this section; (4) require that the insurer establish adequate systems of internal control and reporting to ensure that derivative transactions are properly supervised and that transactions are in accordance with the insurer’s authorized policies and procedures; (5) establish documentation and reporting requirements for transactions authorized pursuant to this section; (6) establish appropriate accounting standards for derivative transactions authorized pursuant to this section; and (7) the provisions of this section shall not be deemed to authorize the superintendent to promulgate any rule or regulation, circular letter or directive, that in any way expands the superintendent’s authority to (i) approve or regulate an insurer’s entire investment portfolio or investment strategy, or (ii) impose standards on corporate governance that are either stricter or contrary to the provisions contained in this article or the business corporation law. …

(l) An insurer may enter into replication transactions provided that: (1) the insurer would otherwise be authorized to invest its funds under this chapter in the asset being replicated; (2) the asset being replicated is subject to all provisions and limitations (including quantitative limits) on the making thereof specified in this chapter with respect to investments by the insurer, as if the transaction constituted a direct investment by the insurer in the asset being replicated; and (3) as a result of giving effect to the replication transaction, the aggregate statement value of all assets being replicated does not exceed ten percent of the insurer’s admitted assets.
(f) Any investment may be denominated in a currency other than United States dollars, provided that the aggregate amount of all such investments (other than investments made pursuant to subparagraphs (A) and (B) of paragraph seven of subsection (a) of this section) that are not effectively hedged, substantially in their entirety, against the United States dollar, reduced, on a currency by currency basis, by the amount of foreign-currency denominated insurance liabilities may not exceed four percent of the insurer’s admitted assets. An investment shall be deemed to be effectively hedged, substantially in its entirety, if it has been hedged: (1) for an insurer that has an approved derivative use plan under section one thousand four hundred ten of this article, pursuant to contracts or agreements entered into under and in accordance with that derivative use plan and subject to the counterparty exposure limits thereunder; or (2) for any other insurer, pursuant to contracts or agreements (derivative transactions) which are cleared through a “derivatives clearinghouse” or entered into with a “qualified counterparty”, as those terms are defined pursuant to subsection (f) of section one thousand four hundred ten of this article.

11 NYCRR 178.0
Section 178.0. Purposes

The purposes of this Part, with respect to derivative instruments used to engage in hedging, replication and certain limited income generation transactions, authorized pursuant to section 1410 of the Insurance Law, are to: (a) define certain terms; (b) establish the content of the derivative use plan to be submitted by an insurer to the superintendent; (c) establish effective management oversight standards, including quarterly reporting to the board of directors or a committee thereof charged with the responsibility for supervising investments; (d) require that the insurer establish adequate systems of internal control and reporting to ensure that derivative transactions are properly supervised and that transactions are in accordance with the insurer’s authorized policies and procedures; (e) establish documentation and reporting requirements; and (f) establish appropriate accounting standards.

11 NYCRR 178.4
Section 178.4. Management oversight standards

(a) In order to address the need for appropriate oversight by senior management and by the board of directors, or a committee thereof charged with the responsibility for supervising investments, and to provide for a comprehensive risk management process for derivative instruments, an insurer shall establish the following with respect to derivative transactions: (1) appropriate limits for various identified risks relevant to the derivative transactions used by the insurer; (2) procedures and practices that control the nature and amount of such risks; (3) adequate systems or processes for identifying and measuring such risks; (4) systems or processes for documenting, monitoring and reporting risk exposures on a timely basis; and (5) systems or processes of internal review and audit to ensure the integrity of the overall risk management process.

(b) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive and review quarterly reports which shall include: information to ascertain that all derivative transactions have been made in accordance with delegations, standards, limitations and investment objectives contained in the derivative use plan; the outstanding derivative positions; the unrealized gains or losses thereon; the derivative transactions closed during the report period; a performance review of the derivative transactions; an evaluation of the risks and benefits of the derivative transactions; and other information necessary to ensure that the internal control procedures are being followed.
(c) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall establish the following management oversight standards for derivative transactions: (1) The board of directors, or a committee thereof charged with the responsibility for supervising investments, has an affirmative obligation to inform management of its desired risk tolerance levels. Management shall appropriately translate these risk tolerance levels into effective policies and procedures that address both individual transactions and entire portfolios. (2) Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive sufficient information to assess the strengths and limitations of the insurer’s risk measurement systems in order to determine appropriate risk limits. The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall consider the information identified by the oversight processes, including the potential for indirect effects of downside performance beyond the insurer’s finances, when they determine and communicate their risk profile. (3) When management or the board of directors, or a committee thereof charged with the responsibility for supervising investments, identifies weaknesses in the risk management process, they shall consider alternatives and take steps to strengthen that process. (4) Actions shall be taken to correct any deficiencies in internal controls relative to derivative transactions, including any deficiencies determined by the independent certified public accountant in the evaluation of accounting procedures and internal controls. (5) Risk oversight functions shall possess independence, authority, and expertise. (6) Issuer and counterparty credit decisions for each transaction shall be consistent with the overall credit standards of the insurer.

11 NYCRR 178.4
Section 178.4. Management oversight standards

(a) In order to address the need for appropriate oversight by senior management and by the board of directors, or a committee thereof charged with the responsibility for supervising investments, and to provide for a comprehensive risk management process for derivative instruments, an insurer shall establish the following with respect to derivative transactions: (1) appropriate limits for various identified risks relevant to the derivative transactions used by the insurer; (2) procedures and practices that control the nature and amount of such risks; (3) adequate systems or processes for identifying and measuring such risks; (4) systems or processes for documenting, monitoring and reporting risk exposures on a timely basis; and (5) systems or processes of internal review and audit to ensure the integrity of the overall risk management process. (b) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive and review quarterly reports which shall include: information to ascertain that all derivative transactions have been made in accordance with delegations, standards, limitations and investment objectives contained in the derivative use plan; the outstanding derivative positions; the unrealized gains or losses thereon; the derivative transactions closed during the report period; a performance review of the derivative transactions; an evaluation of the risks and benefits of the derivative transactions; and other information necessary to ensure that the internal control procedures are being followed. (c) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall establish the following management oversight standards for derivative transactions: (1) The board of directors, or a committee thereof charged with the responsibility for supervising investments, has an affirmative obligation to inform management of its desired risk tolerance levels. Management shall appropriately translate these risk tolerance levels into effective policies and procedures that address both individual transactions and entire portfolios. (2) Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive sufficient information to assess the strengths and limitations of the insurer’s risk measurement systems in order to determine appropriate risk limits. The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall also review management’s response to strengths and limitations identified through oversight processes such as stress testing, independent validation and back-testing of risk measurement models. Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall consider the information identified by the oversight processes, including the potential for indirect effects of downside performance beyond the insurer’s finances, when they determine and communicate their risk profile. (3) When management or the board of directors, or a committee thereof charged with the responsibility for supervising investments, identifies weaknesses in the risk management process, they shall consider alternatives and take steps to strengthen that process. (4) Actions shall be taken to correct any deficiencies in internal controls relative to derivative transactions, including any deficiencies determined by the independent certified public accountant in the evaluation of accounting procedures and internal controls. (5) Risk oversight functions shall possess independence, authority, and expertise. (6) Issuer and counterparty credit decisions for each transaction shall be consistent with the overall credit standards of the insurer.
Section 178.6. Documentation and reporting requirements

In accordance with Part 243 of this Title (Regulation 152), the insurer shall maintain documentation and records relating to each derivative transaction including: (a) the purpose or purposes of the transaction; (b) the assets or liabilities (or portfolios thereof) to which the transaction relates; (c) the specific derivative instruments used in the transaction; (d) for over-the-counter derivative transactions, the name of the counterparty, and counterparty exposure amount; and (e) for exchange-traded derivative instruments, the name of the exchange and the name of the firm handling the trade.

Assessment of the Investment Analysis Office

Model Act

Insurer may, directly or indirectly, engage in derivative transactions under following conditions:

A. General Conditions
   (1) Hedging transactions and certain income generation transactions; Yes (also Replications)
   (2) Must demonstrate hedging characteristics and ongoing effectiveness; YES

B. Limitations on Hedging Transactions
   YES percentage required may differ
   Hedging permitted if, as a result of and after giving effect to the transaction:
   (1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;
   (2) ASV of options, caps and floors does not exceed 3% of admitted assets; and
   (3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions
   YES but different
   ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:
   (1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities; Yes
   (2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold; Yes
   (3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or
   (4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding. Not found

D. Counterparty Exposure
   Counterparty exposure amounts included when determining compliance with limitations. Not Found but assumed to apply

E. Additional Transactions
   Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes.

Model Regulation

Adopted and promulgated by the Commissioner of Insurance YES
Set standards for the prudent use of derivative instruments per Model Act.
Definitions YES
“Business entity”
“Counterparty exposure amount”: YES
“Derivative instrument” – Yes – not identical but substantially so
   ▪ Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or
   ▪ That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
   ▪ Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or any series or combination.
   ▪ Include any agreement, options or instruments permitted under regs under Model Act.
“Qualified clearinghouse” YES
“Qualified exchange” YES
“Qualified foreign exchange”

Guidelines and Internal Control Procedures
Written guidelines, approved by the Commissioner. YES
Objectives for transactions & strategies & risk constraints, including credit risk limits specified; **YES**
Establishes counterparty exposure limits and credit quality standards **YES**
Identifies permissible transactions and relationship to insurer operations;
Requires compliance with internal control procedures. **YES**
Written methodology for determining hedging effectiveness. **YES**
Written policies & procedures describing credit risk management process & system for OTC **YES**
Transactions that measure credit risk exposure using the counterparty exposure amount. **YES requires assessment of accountant**

**Board shall:**
Approve written guidelines, methodology, policies & procedures & systems. **YES**
Determine insurer has adequate professional personnel, technical expertise & systems. **YES**
Review transactions made in accordance with approved guidelines and stated objectives. **YES**
Take action to correct any deficiencies in internal controls. **YES**

**Commissioner Approval**
Written documentation submitted for approval. **YES**
Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management. **YES**

**Documentation Requirements** - Documentation & records for each transaction to contain: **YES**
Purpose of transaction; **YES**
The assets or liabilities to which the transaction relates; **YES**
Specific derivative instrument used in the transaction; **YES**
OTC name of counterparty and market value; and **YES**
Exchange traded name of exchange and of firm that handled trade and market value. **YES**

**Trading Requirements** Each derivative instrument:
Traded on a qualified exchange; **YES**
Entered into with, or guaranteed by, a business entity; **YES**
Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.
2. **Connecticut**

**C.G.S.A. § 38a-102**

§ 38a-102. Investments. Derivative financial transactions. Regulations

(a) Except as otherwise limited or prohibited by sections 38a-102 to 38a-102h, inclusive, or by regulation adopted by the Insurance Commissioner pursuant hereto, a domestic insurance company may make or acquire such investments as are prudent in respect of the business of said insurance company and diversification considerations.

(b) Eligibility of an investment shall be determined at the time of its making or acquisition. Any instrument, including any extension or modification thereof, or collateral taken by a domestic insurer as a result of adverse financial circumstances affecting an investment shall not be considered a new investment for purposes of sections 38a-102 to 38a-102h, inclusive.

(c) Any investment limitation based on the amount of an insurance company’s admitted assets or capital and surplus shall relate to such assets or capital and surplus as shown by the insurance company’s annual statement as of December thirty-first next preceding the date of acquisition.

(d) In the case of a domestic life insurance company, the investment limitations set forth in section 38a-102c shall apply to a separate account only to the extent that reserves for guarantees with respect to (1) benefits guaranteed as to dollar amount and duration or (2) funds guaranteed as to principal amount or stated rate of interest are held in a separate account in accordance with subdivision (3) of subsection (a) of section 38a-433.

(e) Any limitation or prohibition appearing in sections 38a-102 to 38a-102h, inclusive, shall apply only with respect to the section in which it appears and shall not constitute a general prohibition applicable to any other section unless specifically stated. The qualification or disqualification of an investment under one section shall not prevent its qualification in whole or in part under another section and an investment authorized by more than one section may be held under whichever authorizing section the company first elects.

(f) (1) A domestic insurance company doing business in this state may enter into derivative financial transactions, including swaps, options, forwards, futures, caps, floors and collars or similar instruments or combinations thereof, in accordance with subsection (a) of this section. Any such company shall include with its audited financial report a statement by the independent certified public accountant conducting such audit that describes such accountant’s assessment of the internal controls of such company relative to such transactions.

(2) If the independent certified public accountant determines the internal controls relative to such derivative financial transactions to be deficient, such company shall include with the statement set forth in subdivision (1) of this subsection such accountant’s report of such deficiencies and a description of remedial actions taken or proposed to be taken to correct such deficiencies, if such actions are not already described in the accountant’s assessment.

(g) The provisions of sections 38a-102 to 38a-102h, inclusive, shall not apply in whole or in part to any activity which the Insurance Commissioner shall exempt therefrom as consistent with the purpose of preserving the financial integrity of insurance companies for their policyholders. The Insurance Commissioner may adopt such regulations, in accordance with chapter 54,1 as the commissioner deems necessary to carry out the purposes of sections 38a-102 to 38a-102h, inclusive.

**Bulletin FS-14c-00 Use of derivatives instruments January 11, 2000**

… This Department has determined that … prior [guidance] no longer adequately address the derivative instruments available to domestic life, accident and health and property-casualty… insurers... the following guidance with respect to the regulatory oversight of derivatives, is promulgated:

1. Instruments Authorized

(a) Insurers may utilize options, caps, floors, swaps, forwards, futures and collars or similar instruments or combinations thereof.

(b) The terms utilized in (a) above shall have the following meanings: (i) Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying...
instrument, typically without exchanging the instruments themselves. (ii) Options are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. (iii) Forwards are contracts (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument. (iv) Futures are standardized forward contracts traded on a United States or Qualified Foreign Exchange. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies. For purposes of this Bulletin Qualified Foreign Exchange means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions: (A) That has received regulatory comparability relief under Commodity Futures Trading Commission (CFTC) Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC's Regulations, 17 C.F.R. Part 30); (B) That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief under CFTC rules 30.10 (as set forth in Appendix C to part 30 of the CFTC's Regulations, 17 C.F.R. Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or (C) Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC's Office of General Counsel, provided that an exchange, board of trade or contact market that qualifies as a qualified foreign exchange only under this subsection, shall only be a qualified foreign exchange as to foreign stock index futures contracts that are the subject of no-action relief. (v) Caps are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder's (purchaser) risk associated with an increase in a reference rate or index. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. (vi) Floors are option contracts in which the floor writer (seller), in return for a premium, agrees to limit or floor the floor holder's (purchaser) risk associated with a decline in a reference rate or index. Because a floor is an option-based contract, the floor holder has the right but not the obligation to exercise the option. (vii) A collar is a combination of a cap and a floor (one purchased and one written).

2. Permitted Usage

(a) Insurers may utilize derivative instruments authorized in Section 1 above for the following purposes: (i) Hedging (ii) Income Generation or (iii) Replication (Synthetic Asset) Transaction

(b) Terms used in (a) above shall have the following meanings: (i) Hedging is a transaction involving the use of one or more derivative instruments which meets all requirements of one or more of the definitions of hedging adopted by the CFTC or one which is entered into and maintained to manage or reduce: (A) The risk of change in the value, yield, price, cash flow or quantity of assets or liabilities which the insurer has acquired or incurred or anticipates acquiring or incurring; or (B) The currency exchange rate risk or the degree of exposure as to assets or liabilities which an insurer has acquired or incurred or anticipates acquiring or incurring. (ii) Income generation is a derivative transaction involving the writing of covered call options, covered caps or covered floors that is intended to generate income or enhance return. The term covered means that an insurer owns or can immediately acquire, through the exercise of options, warrants or conversion rights already owned, the underlying interest or its economic equivalent in order to fulfill or secure its obligations under a call option, cap or floor it has written in an income generation transaction. For purposes of this Bulletin, economic equivalent means an asset or combination of assets with substantially similar investment-risk attributes as such underlying interest; provided, however, if an insurer uses cash as part of a combination of assets to create any such economic equivalent, the amount of cash must be an incidental part of that economic equivalent. For purposes of this subparagraph, interest means a right, claim or legal share in something, and does not refer to a charge for an extension of credit. (iii) Replication (synthetic asset) transaction is a transaction involving the use of one or more derivative instruments of the types permitted under this Bulletin, entered into in conjunction with other permissible investments in order to reproduce the investment characteristics of otherwise permissible investments. A transaction involving the use of one or more derivative instruments entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction. (c) A collar may be utilized for hedging purposes, for income generation purposes where the portion written by the insurer is covered and for replication purposes as permitted by this Bulletin.

3. Limitations on Hedging Transactions

An insurer may enter into hedging transactions under this Bulletin if, as a result of and after giving effect to the transaction:

(a) The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;
(b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and

(c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets. Potential exposure is a derived measure of the potential increase in derivative instrument credit risk exposure and is determined in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and Annual Statement Instructions Manuals.

Transactions entered into to hedge the currency risk of investments denominated in a currency other than United States dollars shall not be included in the above limits.

An insurer may purchase or sell one or more derivative instruments to offset any derivative instrument previously purchased or sold without regard to the above limits.

4. Limitations on Income Generation Transactions
An insurer may enter into the following types of income generation transactions if as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, does not exceed ten percent (10%) of its admitted assets:
(a) Sales of covered options on non-callable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the noncallable period or derivative instruments based on fixed income securities;
(b) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;
(c) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors throughout the entire period in which the cap or floor is outstanding.

5. Limitations on Replication (Synthetic Asset) Transactions
Any asset being replicated is subject to all of the provisions and limitations on the making thereof specified in Connecticut General Statutes § 38a-102 through § 38a-102i with respect to investments by the insurer as if the replication (synthetic asset) transaction constituted a direct investment by the insurer in the replicated asset.

6. Counterparty Exposure
An insurer may enter into a transaction for an Over-the-Counter Derivative Instrument only with a Qualified Counterparty. Counterparty exposure is the exposure to credit risk associated with the use of Over-the-Counter Derivative Instruments with a Counterparty, determined in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and Annual Statement Instructions Manuals and shall be included in determining compliance with any single or aggregate quantitative limitation on investments made by an insurer under Connecticut General Statute § 38a-102 to § 38a-102i.

Over-the-Counter Derivative Instrument means a derivative instrument which is authorized under this Bulletin and which is entered into with a party other than through a United States or Qualified Foreign Exchange, or cleared through a United States or Qualified Foreign Exchange which provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.

Qualified Counterparty means a party:

(1) that has a Credit Rating of A or better (or the equivalent by at least one nationally recognized statistical rating organization; (2) whose parent has a credit Rating of A or better (or the equivalent) by at least one nationally recognized statistical rating organization; or (3) has Credit Enhancement for all of its financial or settlement obligations under the Over-the-Counter Derivative Instrument for the duration of the transaction from an entity that has a Credit Rating of A or better (or the equivalent) by at least one nationally recognized statistical rating organization for the benefit of the Insurer. Credit Rating means a financial strength rating, issuer rating, senior long-term debt rating or other similar rating which assesses the creditworthiness of a party to meet its financial obligations. Credit Enhancement includes, but is not limited to, a guarantee and/or credit insurance.
7. Guidelines
Each insurer utilizing derivatives shall establish written guidelines stating the policy objectives of management, permissible strategies, the relationship of those strategies to the insurer's operations and how such strategies reduce or control the insurer's market risk and otherwise save transaction costs or substitute for investments or liabilities. The insurer's guidelines shall contain a requirement that its board of directors or committee thereof charged with the responsibility of overseeing investments, establish a procedure to determine, at least annually, that all derivative transactions were made in accordance with policy objectives, permissible strategies, and the insurer's overall investment goals as outlined in its written guidelines.

A copy of such guidelines shall be filed for informational purposes with this Department no later than March 1, 2000. Any subsequent revisions to an insurer's written guidelines shall be filed with the Department, as they become effective. The Department shall treat these guidelines as confidential in accordance with Connecticut General Statute § 38a-69a.

8. Accounting and Reporting
Transactions permitted by this Bulletin shall be accounted for and reported in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and Annual Statement Instructions Manuals.

9. Waiver
This Department, may in its discretion, from time to time waive one or more of the requirements contained in this Bulletin upon the written request of an insurer and a reasonable showing of the need for such waiver.

Assessment of the Investment Analysis Office

Model Act
Insurer may, directly or indirectly, engage in derivative transactions under following conditions:
A. General Conditions
   (1) Hedging transactions and certain income generation transactions; YES Contains limits on Replications
   (2) Must demonstrate hedging characteristics and ongoing effectiveness; YES
B. Limitations on Hedging Transactions YES – same limits
   Hedging permitted if, as a result of and after giving effect to the transaction:
   (1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;
   (2) ASV of options, caps and floors does not exceed 3% of admitted assets; and
   (3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.
C. Limitations on Income Generation Transactions YES same limits
   ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call minus amount of purchase obligations under puts, does not exceed 10% of admitted assets:
   (1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;
   (2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;
   (3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or
   (4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.
D. Counterparty Exposure
   Counterparty exposure amounts included when determining compliance with limitations. YES
E. Additional Transactions
   Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes.

Model Regulation
Adopted and promulgated by the Commissioner of Insurance YES
Set standards for the prudent use of derivative instruments per Model Act. Not explicitly
Definitions YES consistent with NAIC and market generally
“Business entity”
“Counterparty exposure amount”:
“Derivative instrument” –
☐ Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or
☐ That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
☐ Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or
any series or combination. YES

☐ Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”

“Qualified exchange”

“Qualified foreign exchange”

Guidelines and Internal Control Procedures YES

Written guidelines, approved by the Commissioner. No, but must be filed for informational purposes

Objectives for transactions & strategies & risk constraints, including credit risk limits specified;

Establishes counterparty exposure limits and credit quality standards

Identifies permissible transactions and relationship to insurer operations;

Requires compliance with internal control procedures. YES requires independent CPA review

Written methodology for determining hedging effectiveness.

Written policies & procedures describing credit risk management process & system for OTC YES

Transactions that measure credit risk exposure using the counterparty exposure amount. YES

Board shall: YES as to all criteria

Approve written guidelines, methodology, policies & procedures & systems.

Determine insurer has adequate professional personnel, technical expertise & systems.

Review transactions made in accordance with approved guidelines and stated objectives.

Take action to correct any deficiencies in internal controls. YES

Commissioner Approval

Written documentation submitted for approval. No, but required to be filed for informational purposes

Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management. No.

Documentation Requirements - Documentation & records for each transaction to contain: Not found but implied by guidelines on internal cntorl procedures

Purpose of transaction;

The assets or liabilities to which the transaction relates;

Specific derivative instrument used in the transaction;

OTC name of counterparty and market value; and

Exchange traded name of exchange and of firm that handled trade and market value.

Trading Requirements Each derivative instrument:

Traded on a qualified exchange;

Entered into with, or guaranteed by, a business entity;

Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange. YES to all trading requirements.
3. Michigan

M.C.L.A. 500.943

500.943. Derivative instruments

Sec. 943. (1) Qualified assets for purposes of section 901 include derivative instruments only if the insurer is able to demonstrate to the commissioner through cash flow testing or other appropriate analyses both the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of transactions.

(2) Before engaging in a derivative transaction and with board of director approval, a domestic insurer shall do all of the following: (a) Establish written guidelines to be used for effecting or maintaining derivative transactions. The guidelines shall be available to the commissioner on request and shall meet all of the following: (i) Address investment or, if applicable, underwriting objectives and risk constraints, such as credit risk limits. (ii) Address permissible derivative transactions and the relationship of those transactions to its operations. (iii) Require compliance with internal control procedures. (b) Have a system for determining whether a derivative instrument used in a hedging or replication transaction is effective. (c) Have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using counterparty exposure amount. (d) Determine whether the insurer has adequate professional personnel, technical expertise, and systems to implement investment practices involving derivatives. (e) Determine that the derivative program is prudent and that the level of risk is appropriate for the insurer given the level of capitalization and expertise available to the insurer.

(4) The commissioner may promulgate rules pursuant to the administrative procedures act of 1969, 1969 PA 306, MCL 24.201 to 24.328, to implement this section, including, but not limited to, the establishment of all of the following: (a) Financial solvency standards. (b) Valuation standards. (c) Reporting requirements.

(5) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations in section 901(6).

(6) In measuring the net amount of credit risk exposure using counterparty exposure amount, all of the following apply: (a) The net amount of credit risk equals the market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer or zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer. (b) If over-the-counter derivative instruments are entered into pursuant to a written master agreement that provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or, if not within the United States, within a foreign jurisdiction approved as eligible for netting, the net amount of credit risk is the greater of zero or the net sum of the market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment to the insurer and the market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

(7) As used in subsection (6), market value shall be determined for open transactions at the end of the most recent quarter of the insurer’s fiscal year and shall be reduced by the market value of acceptable collateral held by the insurer or placed in escrow by 1 or both parties.

(8) As used in this section: (a) “Cap” means an agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of 1 or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price. (b) “Collar” means an agreement to receive payments as the buyer of an option, cap, or floor, and to make payments as the seller of a different option, cap, or floor. (c) “Collateralized mortgage obligation” means an asset-backed security that has cash flows originating directly or indirectly from underlying mortgage assets. (d) “Counterparty exposure amount” means the net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange or qualified foreign exchange or cleared through a qualified clearinghouse such as an over-the-counter derivative instrument. (e) “Derivative instrument” means any agreement, option, or instrument, or any series or combinations of an agreement, option, or instrument to make or take delivery of, or assume or relinquish, a specified amount of 1 or more underlying interests, or to make a cash settlement in lieu of 1 or more underlying interests, or that has a price, performance, value, or cash flow based primarily upon the actual or expected price, yield, level, performance, value, or cash flow of 1 or more underlying interests. Derivative instruments include options, warrants, caps, floors, collars, swaps, swaptions, forwards, futures, and any other substantially similar agreements, options, or instruments, or any series or combinations and any further agreements, options, or instruments included under rules promulgated by the commissioner. Derivative instruments do not include collateralized
mortgage obligations, other asset-backed securities, principal-protected structured securities, or instruments that an insurer is otherwise permitted to invest in or receive under this chapter other than under this section. The sale or purchase of a derivative instrument by an insurer in connection with a written investment policy that insulates the purchaser from the risk of default of an underlying financial instrument shall be treated as a derivative and not as insurance for purposes of this act. (f) “Derivative transaction” means a transaction involving the use of 1 or more derivative instruments. For purposes of this section, dollar roll transactions, repurchase transactions, reverse repurchase transactions, and securities lending transactions are not derivative transactions. (g) “Floor” means an agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance, or value of 1 or more underlying interests. (h) “Forward” means an agreement, other than a future, to make or take delivery in the future of 1 or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of the underlying interests. Forward includes spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions. (i) “Future” means an agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of 1 or more underlying interests. (j) “Hedging transaction” means a derivative transaction that is entered into and maintained to manage the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities that the insurer has acquired or incurred or anticipates acquiring or incurring or the currency exchange rate risk related to assets or liabilities that an insurer has acquired or incurred or anticipates acquiring or incurring. (k) “Option” means an agreement giving the buyer the right to buy or receive, known as a call option, sell or deliver, known as a put option, enter into, extend, or terminate or effect a cash settlement based on the actual or expected price, spread, level, performance, or value of 1 or more underlying interests. (l) “Replication transaction” means a derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer’s investment portfolio in order to replicate the risks and returns of another authorized transaction, investment, or instrument or to operate as a substitute for cash market transactions. A derivative transaction entered into by the insurer as a hedging transaction is not a replication transaction. (m) “Structured security” means an obligation whose principal or interest payments are determined partially or entirely by reference to an index, market, event, or asset unrelated to the issuer’s ability to pay. (n) “Swap” means an agreement to exchange or to net payments at 1 or more times based on the actual or expected price, yield, level, performance, or value of 1 or more underlying interests. (o) “Swaption” means an option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option. (p) “Underlying interest” means the assets, liabilities, other interests, or a combination of assets, liabilities, or other interests underlying a derivative instrument such as any 1 or more securities, currencies, rates, indices, commodities, or derivative instruments. (q) “Warrant” means an instrument that gives the holder the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times outlined in the warrant agreement. (9) The amendatory act that added this subsection does not affect the validity of any derivative transaction entered into or derivative instrument acquired by an insurer before the effective date of the amendatory act that added this subsection.

Assessment of the Investment Analysis Office

Michigan permits hedging and income generation transactions if insurer demonstrates hedging characteristics and ongoing effectiveness. It does not mention limits on an admitted asset basis. The use of derivatives and defines them consistently with the way they are defined in the NAIC guidance but does not contain any of the detail of the Model Act or Model Regulation. It does not specify limitations on income generation transactions. It does require that counterparty exposures be included when determining compliance with limitations. The statute contains an appropriate definitional structure similar to the one in the NAIC Model Act. The statute contains detailed requirements on internal controls identical to those in the Model Regulation, except that the Commissioner does not appear to require pre-approval. The written guidelines must exist and must be available to the Commission when requested. However, the Commissioner retains broad authority to pass rules to govern the activity. The statute requires that derivative activity be conducted with Board approval and identifies many of the same criteria in the Model Regulation as issues for the Board to address.
4. Minnesota

M.S.A. § 60L.01 Definitions

Subd. 4. Derivative instrument. “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, as provided under applicable annual statement instructions or statutory accounting guidelines.

Subd. 5. Derivative transaction. “Derivative transaction” means a transaction involving the use of one or more derivative instruments. …

Subd. 7. Income generation. “Income generation” means a derivative transaction involving the writing of covered options, caps, or floors that is intended to generate income or enhance return.

Subd. 8. Insurer. “Insurer” means a domestic insurance company, including a fraternal benefit society. …

Subd. 12. Minimum financial security benchmark. “Minimum financial security benchmark” means the amount an insurer is required to have under section 60L.03. …

Subd. 13a. Replicated investment position. “Replicated investment position” means the statement value of the position reported under the heading “Replicated (Synthetic) Asset” on Schedule DB, Part F, of the annual statement of the insurer, or any successor provision.

Subd. 14. Replication transaction. “Replication transaction” means a derivative transaction that is intended to replicate the performance of one or more assets that an insurer is authorized to acquire under sections 60L.01 to 60L.15. A derivative transaction that is entered into as a hedging transaction is not considered a replication transaction.

M.S.A. § 60L.10 - Prohibited investments

Subdivision 1. Prohibitions. An insurer may not invest in investments that are prohibited for an insurer by law. The use of a derivative instrument for any purposes other than hedging, income generation, or replication is prohibited.

Subd. 2. Disposal of prohibited asset. A reasonable time, not to exceed five years, must 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 determines that the sale of the asset would be contrary to the interests of insureds, creditors, or the general public.

Assessment of the Investment Analysis Office

Minnesota has clearly adopted the Defined Standards version of the Investment of Insurers Model Act as demonstrated by the reference to the Minimum Financial Security Benchmark. Derivatives are defined by reference to the NAIC reporting and accounting framework for Derivatives. Hedging is not specifically mentioned but would presumably be subsumed in the definition by reference to the NAIC reporting framework. Income generation is. Limits are not mentioned and the statute does not provide the specificity of a state that has adopted the Defined Limits Version of the Model Act.
5. Iowa

I.C.A. § 511.8 - Investment of funds

22. Financial instruments used in hedging transactions.

e. (1) Investments in financial instruments of foreign governments or foreign corporate obligations, other than Canada, used in hedging transactions shall be included in the limitation contained in subsection 19 that allows only twenty percent of the legal reserve of the company or association to be invested in such foreign investments, except insofar as the financial instruments are collateralized by cash, United States government obligations as authorized by subsection 1, or obligations of or guaranteed by a United States government-sponsored enterprise which on the date they are pledged as collateral are adequately secured and have investment qualities and characteristics wherein the speculative elements are not predominant, which are deposited with a custodian bank as defined in subsection 21, and held under a written agreement with the custodian bank that complies with subsection 21 and provides for the proceeds of the collateral, subject to the terms and conditions of the applicable collateral or other credit support agreement, to be remitted to the legal reserve deposit of the company or association and to vest in the state in accordance with section 508.18 whenever proceedings under that section are instituted.

(2) This paragraph “e” does not authorize the inclusion of financial instruments used in hedging transactions in an insurer’s legal reserve that are in excess of the eligibility limitation provided in paragraph “d” unless the financial instruments are collateralized as provided in this paragraph “e”.

IAC 191-49.1(511) Purpose - The purpose of these rules is to set standards for the prudent use of financial instruments used in hedging transactions in accordance with Iowa Code section 511.8(22). This chapter shall be applicable to the legal reserve funds for all domestic insurers and United States branches of alien insurers entered through this state.

IAC 191-49.2(511) Definitions -

“Business entity” means a sole proprietorship, corporation, limited liability company, association, partnership, joint stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether organized for profit or not for profit.

“Counterparty exposure” means the amount of credit risk attributable to a derivative instrument entered into with a business entity (“over-the-counter derivative instrument”). No counterparty exposure shall be assigned to transactions involving a qualified exchange or qualified foreign exchange or transactions cleared through a qualified clearinghouse. 1. The amount of credit risk equals: a. The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or b. Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer. 2. If the over-the-counter derivative instruments are entered into pursuant to a written master agreement which provides for netting of payments owed by the respective parties, and the domicile of the counterparty is either within the United States or, if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of: a. The market value of the over-the-counter derivative instruments entered into pursuant to the master agreement, the liquidation of which would result in a final cash payment to the insurer; and b. The market value of the over-the-counter derivative instruments entered into pursuant to the master agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity. For any open transactions, market value shall be determined at the end of the most recent quarter of the insurer’s fiscal year and shall be reduced by the market value of acceptable collateral held by the insurer or placed in escrow for the benefit of the insurer by one or both parties.

“Derivative instrument used in a hedging transaction” means an agreement, option, instrument or a series or combination thereof: 1. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or 2. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests. Derivative instruments include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof. Derivative instruments shall additionally include any agreements, options or instruments permitted pursuant to Iowa Code section 511.8(22)”h.“ Derivative instruments shall not include an investment authorized by Iowa Code sections 511.8(1) through 511.8(21).

“Financial instrument used in a hedging transaction“ means a derivative instrument used in a hedging transaction.
“Qualified clearinghouse” means a clearinghouse for, and subject to the rules of, a qualified exchange or a qualified foreign exchange, which provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.


“Qualified foreign exchange” means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions: 1. That has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s regulations, 17 CFR Part 30); 2. That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s regulations, 17 CFR Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or 3. Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC’s Office of General Counsel, but an exchange, board of trade or contract market that qualifies as a “qualified foreign exchange” only under this paragraph shall only be a “qualified foreign exchange” as to foreign stock index futures contracts that are the subject of such no-action relief under this paragraph.

IAC 191-49.3(511) Guidelines and internal control procedures

49.3(1) Before engaging in a derivative transaction pursuant to Iowa Code section 511.8(22), an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall: a. Address investment or, if applicable, underwriting objectives, risk constraints, and the factors considered in establishing risk constraints such as credit risk limits; b. Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and c. Require compliance with internal control procedures.

49.3(2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective. In so doing a company should set specific criteria at the inception of the hedge or hedge program as to what will be considered effective in measuring the hedge and individual hedges in a hedge program and then apply those criteria in the ongoing assessment based on actual hedge results.

49.3(3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount as provided in rule 49.2(511).

49.3(4) The board of directors of the insurer or a committee thereof shall, in accordance with Iowa Code section 511.8(22) (+): a. Approve the guidelines required by subrule 49.3(1) and the systems required by subrules 49.3(2) and 49.3(3); and b. Determine whether the insurer has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.

49.3(5) For purposes of determining whether internal control procedures are in compliance with this rule, the insurance division may consider, but is not limited to, the following items: a. That only the board or its authorized designee can approve derivative instrument transactions; b. That the board or its designee exercise administrative oversight of trading functions; c. That periodic reporting of open positions to chief investment officer occurs; and d. That periodic assessment of the effectiveness of hedging transactions be conducted by persons designated by the board or its designees.

IAC 191-49.4(511) - Documentation requirements - An insurer shall maintain documentation and records relating to each derivative transaction transacted pursuant to Iowa Code section 511.8(22) including, but not limited to: 1. The purpose or purposes of the transaction; 2. The assets or liabilities to which the transaction relates; 3. The specific derivative instrument used in the transaction; 4. For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount calculated not less than quarterly; and 5. For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

IAC 191-93.4(511,521A) - Standards for conduit derivative transactions

93.4(1) Documentation. The conduit shall maintain documentation and records relating to each conduit derivative transaction that shall include, but not be limited to, documentation setting forth: a. The purpose or purposes of the transaction; b. The
specific derivative instrument used in the transaction; c. For over-the-counter derivative instrument transactions, the name of the qualified counterparty and the counterparty exposure amount calculated not less than quarterly; and d. For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

93.4(2) Trading requirements. Each derivative that is the subject of a conduit derivative transaction shall be entered into with a qualified counterparty.

IAC 191-93.5(511,521A) - Internal controls

93.5(1) Before engaging in an aggregated derivative transaction or a conduit derivative transaction, the conduit shall have established written guidelines that shall be used for effecting and maintaining such transactions.

93.5(2) The guidelines shall: a. Address investment or, if applicable, underwriting objectives, risk constraints, and the factors considered in establishing risk constraints such as credit risk limits; b. Address permissible transactions and the relationship of those transactions to the conduit’s operations, such as a precise identification of the risks being hedged by a derivative transaction; c. Set forth a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the qualified counterparty exposure; and d. Require:
(1) Compliance with internal control procedures; (2) That the board of directors of the conduit shall approve the guidelines and determine whether the conduit has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives; (3) That only the board of directors of the conduit or its authorized designee may approve derivative instrument transactions; (4) That the board of directors of the conduit or its designee exercise administrative oversight of trading functions; (5) Periodic reporting of open positions to a responsible officer designated by the board of directors of the conduit; and (6) That the reports set forth in rule 191-93.6(511, 521A) be filed with the Iowa insurance commissioner as required.

Assessment of the Investment Analysis Office

Model Act
Insurer may, directly or indirectly, engage in derivative transactions under following conditions:
A. General Conditions
   (1) Hedging transactions and certain income generation transactions; Only Hedging
   (2) Must demonstrate hedging characteristics and ongoing effectiveness; YES

B. Limitations on Hedging Transactions None mentioned
   Hedging permitted if, as a result of and after giving effect to the transaction:
   (1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;
   (2) ASV of options, caps and floors does not exceed 3% of admitted assets; and
   (3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions Not mentioned
   ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:
   (1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;
   (2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;
   (3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or
   (4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.

D. Counterparty Exposure Not mentioned
   Counterparty exposure amounts included when determining compliance with limitations.

E. Additional Transactions Not discussed
   Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes.

Model Regulation
Adopted and promulgated by the Commissioner of Insurance
Set standards for the prudent use of derivative instruments per Model Act. YES but mentions hedging only

Definitions
“Business entity”
“Counterparty exposure amount”:
“Derivative instrument” – Same as Model Regulation

- Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or
- That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
- Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or any series or combination.
- Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”
“Qualified exchange”
“Qualified foreign exchange”

Guidelines and Internal Control Procedures
Written guidelines, approved by the Commissioner. Comm approval not required but all other standards addressed
Objectives for transactions & strategies & risk constraints, including credit risk limits specified;
Establishes counterparty exposure limits and credit quality standards
Identifies permissible transactions and relationship to insurer operations;
Requires compliance with internal control procedures. Written methodology for determining hedging effectiveness.
Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk exposure using the counterparty exposure amount.

Board shall:
Approve written guidelines, methodology, policies & procedures & systems. YES
Determine insurer has adequate professional personnel, technical expertise & systems. YES
Review transactions made in accordance with approved guidelines and stated objectives. YES
Take action to correct any deficiencies in internal controls. YES

Commissioner Approval No but reports are required to be filed with the Commissioner
Written documentation submitted for approval.
Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management.

Documentation Requirements – All documentation standards in the Model are contained in the statute
Documentation & records for each transaction to contain:
Purpose of transaction;
The assets or liabilities to which the transaction relates;
Specific derivative instrument used in the transaction;
OTC name of counterparty and market value; and
Exchange traded name of exchange and of firm that handled trade and market value.

Trading Requirements Each derivative instrument: Yes requires a qualified counterparty
Traded on a qualified exchange;
Entered into with, or guaranteed by, a business entity;
Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.
6. Delaware

18 Del. Admin. Code 404-4.0 - Permitted Usage

4.1 Insurers may utilize derivative instruments for the following purposes: 4.1.1 Hedging transactions, as defined in Section 2.0 and to the extent permitted by Section 5.0 of this regulation; 4.1.2 Income generation transactions, as defined in Section 2.0 and to the extent permitted by Section 6.0 of this regulation; and 4.1.3 Replication (synthetic asset) transactions, as defined in Section 2.0 and to the extent permitted by Section 7.0 of this regulation…

18 Del. Admin. Code 404-5.0 - Limitations on Hedging Transactions

5.1 An insurer may use derivative instruments for hedging transactions under this regulation if, as a result of and after giving effect to the transaction: 5.1.1 The aggregate statement value of options, swaptions, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets; 5.1.2 The aggregate statement value of options, swaptions, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and 5.1.3 The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets…


6.1 An insurer may enter into the following types of income generation transactions: 6.1.1 Sales of covered call options on (i) non-callable fixed income securities, (ii) callable fixed income securities if the option expires by its terms prior to the end of the non-callable period, (iii) derivative instruments based on fixed income securities, or (iv) equity securities; 6.1.2 Sales of covered put options on investments that the insurer is permitted to acquire under 18 Del.C. Chapter 13; and 6.1.3 Sales of covered caps or floors.

6.2 For purposes of this Section 6.0, the term “covered” means that an insurer (i) owns or can immediately acquire, through the exercise of options, warrants or conversion rights already owned, the underlying interest in order to fulfill or secure its obligations under a call option it has sold, (ii) holds cash equivalents or segregated cash with a market value equal to the amount required to fulfill its obligations under a put option it has sold, or (iii) holds in its portfolio (A) investments generating the cash flow, or (B) cash equivalents or segregated cash with a market value, in each case, sufficient to make the required payments under a cap or floor it has sold.

6.3 In connection with an insurer’s income generation transactions under Section 6.1, the sum total of the following items shall not exceed ten percent (10%) of an insurer’s admitted assets: (i) the aggregate statement value of the equity or fixed income securities that are subject to covered call options, plus (ii) the aggregate statement value of the assets that generate the cash flows or are sufficient to make the required payments under covered caps and floors, plus (iii) the face value of fixed income securities underlying a derivative instrument subject to a covered call option, plus (iv) the aggregate amount of the purchase obligation under covered put options.

6.4 An insurer utilizing income generation transactions must at all times (i) be able to identify on its books and records, without duplication, its ownership of, or right to acquire, the investments, cash or cash equivalents required under Section 6.2 to be held in connection with the income generation transactions authorized under Section 6.1, and (ii) maintain a separate record that (A) lists all of the insurer’s outstanding income generation transactions under Section 6.1, and (B) demonstrates how those transactions are “covered” as required under Section 6.2, by the insurer’s ownership of, or right to acquire, underlying interests, designated investments, cash or cash equivalents. Such record shall be submitted to the Department upon its request.

18 Del. Admin. Code 404-2.0 Definitions

The following words and terms, when used in this regulation, shall have the following meaning unless the context clearly indicates otherwise:

“Aggregate statement value” means the sum of the statement values of individual derivative instruments. In calculating this sum, an insurer shall assign absolute values to negative values.

“Cap” means an agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined
number, sometimes called the strike rate or strike price.

“Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor.

“Counterparty exposure” means the net amount of credit risk attributable to an over-the-counter derivative instrument determined as follows: (1) For an over-the-counter derivative instrument not entered into under or subject to a written master agreement which provides for netting of payments owed by the respective parties: (i) the market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or (ii) zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer. (2) For over-the-counter derivative instruments entered into under or subject to a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign (not United States) jurisdiction deemed by the SVO as eligible for netting, the greater of zero or the net sum payable to the insurer in connection with all derivative instruments subject to the written master agreement upon their liquidation in the event of default by the counterparty under the master agreement (assuming no conditions precedent to the obligations of the counterparty to make such a payment and assuming no setoff of amounts payable under any other instrument or agreement). (3) For the purposes of this definition, market value or the net sum payable, as the case may be, shall be determined at the end of the most recent quarter of the insurer’s fiscal year and will be reduced by the market value of acceptable collateral held by the insurer or a custodian on the insurer’s behalf...

“Derivative instrument” means an agreement, instrument or a series or combination thereof: (a) to make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or (b) that has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests or is dependent on the occurrence or nonoccurrence of any event associated with one or more potential financial, economic, or commercial consequences. The term “derivative instrument” includes, without limitation, options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, swaptions, forwards, futures and any other agreements or instruments substantially similar thereto or any series or combination thereof. The term “derivative instrument” does not include other categories of investments specifically authorized under 18 Del.C. Chapter 13.

“Derivative transaction” means a transaction involving the use of one or more derivative instruments.

“Derivatives clearinghouse” means a derivatives clearing organization registered with the Commodity Futures Trading Commission or the Securities Exchange Commission or regulated, supervised and examined by a foreign regulatory authority.

“Floor” means an agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, ...

“Forward” means an agreement (other than a future) to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance or value of such underlying interests, but shall not mean or include spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

“Future” means an agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more underlying interests.

“Hedging transaction” is a derivative transaction which is entered into and maintained to manage or reduce: (1) The risk of change in the value, yield, price, cash flow or quantity of assets or liabilities which the insurer has acquired or incurred or anticipates acquiring or incurring, or; (2) The currency exchange rate risk or the degree of exposure as to assets or liabilities which an insurer has acquired or incurred or anticipates acquiring or incurring.

“Income generation transaction” is a transaction involving a derivative instrument set forth in Section 6.0 of this regulation that is intended to generate income or enhance return. Other types of derivative instruments may not be used in income generation transactions.

“Option” means an agreement giving the buyer the right but not the obligation to buy or receive (a “call option”), sell or deliver (a “put option”), enter into, extend or terminate or effect a cash settlement based on the actual or expected price, spread, level, performance or value of one or more underlying interests.

“Over-the-counter derivative instrument” means a derivative instrument the use of which is authorized under this regulation other than a derivative instrument (i) cleared through a U.S. or foreign derivatives clearinghouse or (ii) traded on or through a U.S. or foreign exchange.

“Potential exposure” means a statistically derived measure of the potential increase in derivative instrument credit risk exposure, for derivative instruments which generally do not have an initial cost paid or consideration received, resulting from future fluctuations in the underlying interests upon which derivative instruments are based. For collars, swaps and forwards, the potential exposure = 0.5% x notional amount x square root of (remaining years to maturity). For futures, the potential exposure = (initial margin per contract on the valuation date, set by the exchange on which contract trades) x (the number of
contracts open on the valuation date).

“Qualified counterparty” means a counterparty: (1) Which has a designation of “1” or “2” by the SVO, or an investment grade credit rating from at least one nationally recognized statistical rating organization; and (2) With which the insurer has entered into a master agreement, together with a credit support annex or other documentation providing for the collateralization of the counterparty’s obligations to the insurer under the master agreement, if that collateral documentation provides for (i) daily margin and collateral settlement, (ii) a minimum transfer amount of no more than one million dollars, and (iii) a requirement that collateral be provided by the counterparty from the first dollar of exposure, subject to the minimum transfer amount. For this purpose “minimum transfer amount” means an amount below which a daily margin and collateral settlement is not required.

“Replication (synthetic asset) transaction” means a derivative transaction entered into in conjunction with other permissible investments under 18 Del.C. Chapter 13 in order to reproduce the investment characteristics of investments otherwise permissible under 18 Del.C. Chapter 13. A derivative transaction entered into by an insurer as a hedging transaction or income generation transaction shall not be considered a replication (synthetic asset) transaction…

“Swap” means an agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance or value of one or more underlying interests.

“Swaption” means an option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

“Underlying interest” means the assets, liabilities, other interests or a combination thereof underlying a derivative instrument, such as any one or more securities, currencies, rates, indices, commodities or derivative instruments.

18 Del. Admin. Code 404-3.0 - Purpose

The purpose of this regulation is to set standards for the prudent use of derivative instruments by domestic insurers under 18 Del.C. Chapter 13.

18 Del. Admin. Code 404-8.0 - Counterparty Exposure

8.1 Counterparty exposure with respect to over-the-counter derivative instruments, other than with respect to a counterparty that is an affiliate of the insurer approved by the Commissioner in accordance with Section 8.2.3 of this regulation, shall be included in determining compliance with any single or aggregate quantitative limitation on investments made by an insurer under 18 Del.C. Chapter 13. 8.2 An insurer may enter into a transaction for any over-the-counter derivative instrument only with: 8.2.1 A qualified counterparty; 8.2.2 A counterparty, other than a qualified counterparty, provided that (1) the aggregate counterparty exposure of the insurer to any single counterparty, other than a qualified counterparty, shall be limited to one percent (1%) of the insurer’s admitted assets, and (2) the aggregate counterparty exposure of the insurer to all counterparties, other than qualified counterparties, shall be limited to three percent (3%) of the insurer’s admitted assets; or 8.2.3 A counterparty that is an affiliate of the insurer, if (a) the Commissioner has approved of the application of 18 Del.C. § 5933 to such affiliate, in accordance with subsection (h) thereof, or (b) the Commissioner has approved of over-the-counter transactions with such affiliate in accordance with 18 Del.C. § 5005.

8.3 If (i) a counterparty that met the definition of “qualified counterparty” (set forth in Section 2.0 of this regulation) at the time that an insurer entered into a derivative instrument with such counterparty subsequently ceases to satisfy the definition of “qualified counterparty” while such derivative instrument remains in effect, and (ii) as a result of such change in the status of the counterparty, such insurer will exceed the limits set forth in Section 8.2.2 of this regulation, such insurer shall, within 30 days of such change in the status of the counterparty, provide written notice to the Department. Derivative instruments entered into with such counterparty that were acquired in compliance with this regulation need not be divested by an insurer if they exceed the limits set forth in Section 8.2.2 of this regulation. In the event that such insurer desires to enter into additional derivative instruments with such counterparty while such limit has been exceeded, the insurer may request a waiver in accordance with Section 12.1 of this regulation. No further derivative instruments subject to such exceeded limit may be entered into without such waiver.


9.1 Each insurer utilizing derivative instruments shall establish written guidelines stating the policy objectives of management, applicable risk constraints and investment limitations, permissible strategies, the relationship of those strategies to the insurer’s operations and how such strategies reduce or control the insurer’s market risk or otherwise save transaction costs or substitute for investments or liabilities. The insurer’s board of directors, or committee thereof charged with the
Responsibility of overseeing investments, shall approve the written guidelines and any amendment thereto and shall establish a procedure to determine, at least annually, that all derivative transactions were made in accordance with policy objectives, permissible strategies, the insurer’s overall investment goals as outlined in its written guidelines, as well as adherence to and compliance with this regulation. The insurer’s written guidelines shall address these requirements of the board or investment committee.

9.2 Insurers utilizing derivative instruments on or after the effective date of this regulation and prior to April 1, 2015 shall file a copy of such guidelines for informational purposes with the Department no later than April 1, 2015. Each other insurer shall file a copy of such guidelines for informational purposes with the Department prior to the use of any derivative instruments by such insurer. Any subsequent revisions to an insurer’s written guidelines shall be filed with the Department as they become effective.

18 Del. Admin. Code 404-10.0 - Documentation Requirements

10.1 An insurance company shall maintain documentation and records relating to each derivative transaction, such as: 10.1.1 The purpose or purposes of the transaction; 10.1.2 The assets or liabilities to which the transaction relates; 10.1.3 The specific derivative instrument used in the transaction; 10.1.4 For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure; and 10.1.5 For derivative instruments traded on or through an exchange or derivative clearinghouse, the name of the exchange or derivative clearinghouse and the name of the relevant execution and clearing firms.

10.2 An insurer utilizing hedging transactions shall have a written methodology for determining whether derivative instruments used for hedging have been effective.

10.3 All guidelines and notices submitted by an insurer pursuant to Sections 5.4, 8.3 or 9.0 of this regulation that are in the possession of or control of the Department shall be confidential by law and privileged, shall not be subject to this State’s Freedom of Information Act, 29 Del.C. §§ 10001, et. seq., shall not be subject to subpoena, and shall not be subject to discovery or admissible in evidence in any private civil action.

Assessment of the Investment Analysis Office

Model Act

Insurer may, directly or indirectly, engage in derivative transactions under following conditions:

A. General Conditions YES and mentions Replication transactions as well.

(1) Hedging transactions and certain income generation transactions; YES
(2) Must demonstrate hedging characteristics and ongoing effectiveness; YES

B. Limitations on Hedging Transactions Same as in Model Act

Hedging permitted if, as a result of and after giving effect to the transaction:

(1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;
(2) ASV of options, caps and floors does not exceed 3% of admitted assets; and
(3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions YES same concepts and text as in Model Act

ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets;

(1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;
(2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;
(3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or
(4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.

D. Counterparty Exposure

Counterparty exposure amounts included when determining compliance with limitations. YES
E. Additional Transactions

Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes.

Model Regulation

Adopted and promulgated by the Commissioner of Insurance

Set standards for the prudent use of derivative instruments per Model Act. YES

Definitions

“Business entity”

“Counterparty exposure amount”: YES

“Derivative instrument” – Same as Model Regulation

- Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or
- That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
- Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or any series or combination.
- Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”

“Qualified exchange”

“Qualified foreign exchange”

Guidelines and Internal Control Procedures All standards addressed in statute except as noted

Written guidelines, approved by the Commissioner. Comm approval not required but filing with Comm is.

Objectives for transactions & strategies & risk constraints, including credit risk limits specified;

Establishes counterparty exposure limits and credit quality standards

Identifies permissible transactions and relationship to insurer operations;

Requires compliance with internal control procedures. Written methodology for determining hedging effectiveness.

Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk exposure using the counterparty exposure amount.

Board shall:

Approve written guidelines, methodology, policies & procedures & systems. YES

Determine insurer has adequate professional personnel, technical expertise & systems. YES

Review transactions made in accordance with approved guidelines and stated objectives. YES

Take action to correct any deficiencies in internal controls. YES

Commissioner Approval No but reports are required to be filed with the Commissioner

Written documentation submitted for approval.

Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management.

Documentation Requirements – All documentation standards in the Model are contained in the statute

Documentation & records for each transaction to contain: YES

Purpose of transaction;

The assets or liabilities to which the transaction relates; YES

Specific derivative instrument used in the transaction;

OTC name of counterparty and market value; and YES

Exchange traded name of exchange and of firm that handled trade and market value. YES

Trading Requirements Each derivative instrument: Yes requires a qualified counterparty

Traded on a qualified exchange;

Entered into with, or guaranteed by, a business entity;

Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.
7. Ohio

**ORC § 3907.14 Investment of capital, surplus and accumulations**

(2)(a) “Derivative instrument” means an agreement, option, instrument, or a series or combination thereof of either of the following types: (i) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; (ii) That has a price, performance, value, or cash flow based primarily upon the actual or expected price, level, performance, value, or cash flow of one or more underlying interests. (b) Derivative instruments include options, warrants, caps, floors, collars, swaps, forwards, futures, and any other agreements, options, or instruments substantially similar thereto or any series or combination thereof.

(3) “Derivative transaction” means a transaction involving the use of one or more derivative instruments. (4) “Hedging transaction” means a derivative transaction that is entered into and maintained to reduce either of the following: (a) The risk of economic loss due to a change in the value, yield, price, cash flow, or quantity of assets or liabilities that the insurer has acquired or incurred or anticipates acquiring or incurring; (b) The currency exchange rate risk or the degree of exposure as to assets or liabilities that an insurer has acquired or incurred or anticipates acquiring or incurring. (5) “Income generation” means a derivative transaction involving the writing of covered options, caps, or floors that is intended to generate income or enhance return. (6) “Replication transaction” means a derivative transaction that is intended to replicate the performance of one or more assets that an insurer is authorized to acquire under this chapter. “Replication transaction” does not include a derivative transaction that is entered into as a hedging transaction.

(V)(1) Prior to an insurer entering into derivative transactions, the board of directors of the insurer shall approve a derivative use plan.

(2) An insurer shall notify the superintendent of insurance in writing within three days after identifying either of the following: (a) Any event or occurrence related to an insurer’s derivatives use that may lead to a material change to the insurer’s policyholder surplus; (b) Any event or occurrence related to an insurer’s derivatives use that, with the passage of time, may lead to a material change to the insurer’s policyholder surplus.

(3) Prior to entering into derivative transactions, an insurer shall file with the superintendent a copy of its derivative use plan and internal controls, for informational purposes. The insurer shall keep current the copy of its derivative use plan and internal controls filed with the superintendent. The insurer shall not enter into derivative transactions until thirty calendar days after the date on which the derivative use plan and internal controls is filed with the superintendent. This thirty-calendar-day period is to begin on the date that the superintendent receives the derivative use plan and internal controls.

(4) The superintendent may adopt rules prescribing the form and content of derivative use plans, as well as any internal controls the superintendent considers necessary.

(5) An insurer that engages in hedging transactions or replication transactions shall do both of the following:

(a) Maintain its position in any outstanding derivative instrument used as part of a hedging transaction or replication transaction for as long as the hedging transaction or replication transaction continues to be effective;

(b) Demonstrate to the superintendent, upon request, that any derivative transaction entered into and involving hedging transaction or replication transaction is an effective hedging transaction or replication transaction. The insurer must be able to demonstrate this at the time the derivative transaction is entered into, and for as long as the transaction continues to be in place.

(6) An insurer may not invest in, or use, a derivative instrument for any purpose other than a hedging transaction, income generation, or replication.

(7) An insurer shall not invest in, or use a derivative instrument for purposes of income generation in a sum exceeding in the aggregate five per cent of its admitted assets, as of the preceding thirty-first day of December.

(8) All documents provided to the superintendent under division (V) of this section shall be deemed trade secrets and shall be provided with trade secret protection. Such documents shall also be considered work papers of the superintendent that are subject to section 3901.48 of the Revised Code and are confidential and privileged and shall not be considered a public record, as defined in section 149.43 of the Revised Code. The original documents and any copies of them shall not be subject to subpoena and shall not be made public by the superintendent or any other person, except as otherwise provided in section 3901.48 of the Revised Code.

**ORC 3901-3-12 - Derivative use plan**

(A) Purpose - The purpose of this rule is to establish the content of the derivative use plans to be filed with the superintendent as required by sections 3906.12, 3907.14, and 3925.08 of the Revised Code.
(B) Authority - This rule is promulgated pursuant to the authority vested in the superintendent under sections 3901.041, 3906.12, 3907.14 and 3925.08 of the Revised Code.

(C) Derivative use plan

(1) The insurer shall submit a derivative use plan, or amendment thereto, to the superintendent. The derivative use plan or the amendment thereto will be referred to as “the plan” hereinafter. The filing shall include a certified copy of the authorization by the insurer’s board of directors, or a committee thereof charged with the responsibility for supervising investments, pursuant to sections 3906.12, 3907.14 and 3925.08 of the Revised Code. When submitting its plan, the insurer shall also provide to the superintendent: (a) In the event the plan is adopted by a committee of the insurer’s board of directors, information with respect to the composition, in terms of title and position, of such committee; and (b) The name and title of the senior most investment person responsible for derivative transactions; a description of his or her duties and responsibilities, as well as a curriculum vitae or equivalent document. Such information shall be updated and provided to the superintendent as changes occur.

(2) The plan shall contain written guidelines to be followed in engaging in derivative transactions. The guidelines shall include or address: (a) The type, maturity and diversification of derivative instruments; (b) The limitation on counterparty exposures, including limitations based on credit ratings; (c) The limitations on the use of derivatives; (d) Asset/liability management practices with respect to derivative transactions; (e) The liquidity needs and the company’s capital and surplus as it relates to the derivative use plan; (f) The policy objectives of management specific enough to outline permissible derivative strategies; (g) The relationship of the derivative strategies to the insurer’s operations; (h) A requirement that management establishes and executes management oversight standards as required by paragraph (D) of this rule and a description of these standards; (i) A requirement that management establishes and executes internal controls and reporting standards as required by paragraph (E) of this rule and a description of these standards; and (j) A requirement that management establishes and executes documentation and reporting standards as required by paragraph (F) of this rule and a description of these standards.

(3) The plan shall contain, to the extent applicable to the specific derivative transactions authorized, guidelines for the insurer’s acceptable levels of basis risk, credit risk, foreign currency risk, interest rate risk, market risk, operational risk and option risk. The plan shall also provide that the board of directors, or a committee thereof charged with the responsibility for supervising investments, and senior management shall comply with risk oversight functions and adhere to laws, rules, regulations, prescribed practices or ethical standards.

(D) Management oversight standards

(1) In order to address the need for appropriate oversight by senior management and by the board of directors, or a committee thereof charged with the responsibility for supervising investments, and to provide for a comprehensive risk management process for derivative instruments, an insurer shall establish the following with respect to derivative transactions: (a) Appropriate limits for various identified risks relevant to the derivative transactions used by the insurer; (b) Procedures and practices that control the nature and amount of such risks; (c) Adequate systems or processes for identifying and measuring such risks; (d) Systems or processes for documenting, monitoring and reporting risk exposures on a timely basis; and (e) Systems or processes of internal review and audit to ensure the integrity of the overall risk management process.

(2) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive and review quarterly reports which shall include: (a) Information to ascertain that all derivative transactions have been made in accordance with delegations, standards, limitations and investment objectives contained in the derivative use plan; (b) The outstanding derivative positions; the unrealized gains or losses thereon; (c) The derivative transactions closed during the report period; (d) A performance review of the derivative transactions; (e) An evaluation of the risks and benefits of the derivative transactions; and (f) Other information necessary to ensure that the internal control procedures are being followed.

(3) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall establish the following management oversight standards for derivative transactions: (a) The board of directors, or a committee thereof charged with the responsibility for supervising investments, has an affirmative obligation to prior approve its desired risk tolerance levels. Management shall appropriately translate these risk tolerance levels into effective policies and procedures that address both individual transactions and entire portfolios; (b) Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive sufficient information to assess the strengths and limitations of the insurer’s risk measurement systems in order to determine appropriate risk limits. The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall also review management’s response to strengths and limitations identified through oversight processes such as stress testing, independent validation and back-testing of risk measurement models. Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall consider the information identified by the oversight processes, including the potential for indirect effects of downside performance beyond the insurer’s finances, when they determine and communicate their risk profile; (c) When management or the board of directors, or a committee thereof charged with the responsibility for
supervising investments, identifies weaknesses in the risk management process, they shall consider alternatives and take steps to strengthen that process; (d) Actions shall be taken to correct any deficiencies in internal controls relative to derivative transactions, including any deficiencies determined by the independent certified public accountant in the evaluation of accounting procedures and internal controls; (e) Risk oversight functions shall possess independence, authority, and expertise; and (f) Issuer and counterparty credit decisions for each transaction shall be consistent with the overall credit standards of the insurer.

(E) Internal controls and reporting: Before engaging in derivative transactions, an insurer shall establish adequate internal control procedures to deal with derivatives, which shall include but not be limited to: (1) Systems or processes for periodic valuation of derivative transactions including mechanisms for compensating for any lack of independence in valuing trading positions; (2) Systems or processes for determining whether a derivative instrument used for hedging has been effective; (3) Credit risk management systems or processes for over-the-counter derivative transactions that measure credit risk exposure using the counterparty exposure amount and clearly articulated policies for the establishment of collateral arrangements with counterparties; (4) A determination of whether the insurer has adequate professional personnel, technical expertise and systems to implement and control investment practices involving derivatives; (5) Systems or processes for regular reports to management, segregation of duties and internal review procedures; and (6) Systems or procedures for conducting initial and ongoing legal review of derivative transactions including assessments of contract enforceability.

(F) Documentation and reporting requirements: The insurer shall maintain documentation and records relating to each derivative transaction including: (1) The purpose or purposes of the transaction; (2) The assets or liabilities (or portfolios thereof) to which the transaction relates; (3) The specific derivative instruments used in the transaction; (4) For over-the-counter derivative transactions that measure credit risk exposure using the counterparty exposure amount and clearly articulated policies for the establishment of collateral arrangements with counterparties; (4) A determination of whether the insurer has adequate professional personnel, technical expertise and systems to implement and control investment practices involving derivatives; (5) Systems or processes for regular reports to management, segregation of duties and internal review procedures; and (6) Systems or procedures for conducting initial and ongoing legal review of derivative transactions including assessments of contract enforceability.

(G) Severability. If any paragraph, term or provision of this rule is adjudged invalid for any reason, the judgment shall not affect, impair or invalidate any other paragraph, term or provision of this rule, but the remaining paragraphs, terms and provisions shall be and continue in full force and effect.

Assessment of the Investment Analysis Office

Model Act

Insurer may, directly or indirectly, engage in derivative transactions under following conditions:

A. General Conditions

1. Hedging transactions and certain income generation transactions; YES and includes Replication

2. Must demonstrate hedging characteristics and ongoing effectiveness; YES

B. Limitations on Hedging Transactions A general 5% limit mentioned

Hedging permitted if, as a result of and after giving effect to the transaction:

1. Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;

2. ASV of options, caps and floors does not exceed 3% of admitted assets; and

3. Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions – No

ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:

1. Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;

2. Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;

3. Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or

4. Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.

D. Counterparty Exposure Not Discussed

Counterparty exposure amounts included when determining compliance with limitations.

E. Additional Transactions Not Discussed

Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes.

Model Regulation

Adopted and promulgated by the Commissioner of Insurance

Set standards for the prudent use of derivative instruments per Model Act. YES (sets standard for derivative use plan)

Definitions YES has relevant definitions

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“Business entity”

“Counterparty exposure amount”:
“Derivative instrument” – YES
• Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount
  of one or more underlying interests; make cash settlement; or
• That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or
  cash flow of one or more underlying interests.
• Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments
  substantially similar or any series or combination.
• Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”

“Qualified exchange”

“Qualified foreign exchange”

Guidelines and Internal Control Procedures YES but uses different text in some instances from that used in Model Regulation
Written guidelines, approved by the Commissioner. Comm does not approve but must be notified if certain events occur.

Derivatives use plan must be filed with the Comm. With 30 day period for comment
Objectives for transactions & strategies & risk constraints, including credit risk limits specified; YES
Establishes counterparty exposure limits and credit quality standards YES
Identifies permissible transactions and relationship to insurer operations; YES
Requires compliance with internal control procedures. YES
Written methodology for determining hedging effectiveness. YES
Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk
exposure using the counterparty exposure amount. YES

Board shall: Board must approve derivative use plan
Approve written guidelines, methodology, policies & procedures & systems. YES
Determine insurer has adequate professional personnel, technical expertise & systems. YES
Review transactions made in accordance with approved guidelines and stated objectives. YES
Take action to correct any deficiencies in internal controls. YES
Written documentation submitted for approval. Must be submitted on 30 days period
Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management. Implied given 30 day notice period
and provision that rules can be developed and imposed.

Documentation Requirements – YES as to all standards below
Documentation & records for each transaction to contain:
Purpose of transaction;
The assets or liabilities to which the transaction relates;
Specific derivative instrument used in the transaction;
OTC name of counterparty and market value; and
Exchange traded name of exchange and of firm that handled trade and market value.

Trading Requirements Each derivative instrument:
Traded on a qualified exchange;
Entered into with, or guaranteed by, a business entity;
Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign
exchange.
C 27-1-12-2.2 Derivative transactions
Sec. 2.2. (a) The following definitions apply to this section:

(1) “Acceptable collateral” means, as to over-the-counter derivatives transactions and for the purpose of calculating counterparty exposure amounts: (A) cash; (B) cash equivalents; (C) letters of credit; and (D) direct obligations of, or securities that are fully guaranteed as to principal and interest by, the government of the United States or any agency of the United States, including the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

(2) “Business entity” means: (A) a sole proprietorship; (B) a corporation; (C) a limited liability company; (D) an association; (E) a partnership; (F) a joint stock company; (G) a joint venture; (H) a mutual fund; (I) a trust; (J) a joint tenancy; or (K) another, similar form of business organization; whether organized for-profit or not-for-profit.

(3) “Cap” means an agreement obligating the seller to make payments to the buyer, with each payment based on the amount by which a reference price or level or the performance or value of one (1) or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

(4) “Cash” means any of the following: (A) United States denominated paper currency and coins. (B) Negotiable money orders and checks. (C) Funds held in any time or demand deposit in any depository institution, the deposits of which are insured by the Federal Deposit Insurance Corporation.

(5) “Cash equivalent” means any of the following: (A) A certificate of deposit issued by a depository institution, the deposits of which are insured by the Federal Deposit Insurance Corporation. (B) A banker’s acceptance issued by a depository institution, the deposits of which are insured by the Federal Deposit Insurance Corporation. (C) A government money market mutual fund. (D) A class one money market mutual fund.

(6) “Collar” means two (2) derivatives transactions on the same underlying interest in which the insurer receives payments as the buyer of an option, cap, or floor in one (1) transaction and makes payments as the seller of a different option, cap, or floor in the second transaction.

(7) “Counterparty” means any business entity to which a life insurance company enters into a contract or other transaction. “Counterparty” does not include the insurer itself.

(8) “Counterparty exposure amount” means the net amount of credit risk attributable to a derivative instrument that a life insurance company enters into with another business entity other than through a qualified exchange or a qualified foreign exchange, or cleared through a qualified clearing house (“over-the-counter derivative instrument”). The amount of credit risk equals: (1) the market value of the over-the-counter derivative instrument, if the liquidation of the instrument would result in a final cash payment to the insurer; or (2) zero (0), if the liquidation of the over-the-counter derivative instrument would not result in a final cash payment to the insurer. B. If a life insurance company enters into one (1) or more over-the-counter derivative instruments with another business entity under a written master agreement that provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or a foreign jurisdiction listed in the “Purposes and Procedures of the Securities Valuation Office” or any successor publication as eligible for netting, the net amount of credit risk attributable to the counterparty is the greater of zero (0) or the remainder of: (1) the market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer by the business entity; minus (2) the market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity. C. For open transactions involving over-the-counter derivative instruments, market value: (1) shall be determined not less frequently than at the end of the most recent quarter of the insurer’s fiscal year; and (2) shall be reduced by the market value of acceptable collateral that is: (A) held by the insurer; or (B) placed in escrow by one (1) or both parties.

(9) “Covered” means, in the case of a call option, that: (A) the life insurance company owns the instrument underlying the call option it has written (a “written call”) during the entire period that the written call is outstanding; or (B) pursuant to the exercise of options, warrants, or conversion rights already owned when the call option is written and held during the period that the written call is outstanding, the life insurance company can immediately acquire the instrument underlying the written call; or (2) the life insurance company has placed in escrow or, pursuant to a custodian agreement, has segregated during the entire period that the written call is outstanding, cash, cash equivalents, or securities with a market value equal to the difference between the price at which the underlying instrument can be acquired and the strike price of the written call.

(10) “Covered” means, in the case of a put option, that the life insurance company has placed in escrow or, pursuant to a custodian agreement, has segregated during the entire period that the put option it has sold (a “written put”) is outstanding, cash, cash equivalents, or securities with a market value equal to the amount of the insurer’s obligation under the written put.

(11) “Covered” means, in the case of a cap or floor, that the life insurance company holds in its portfolio, during the entire period that the cap or floor is outstanding, investments that generate sufficient cash flow to make all required payments under the cap or floor.

(12) “Derivative instrument” means an agreement (in the nature of a bilateral contract, option, or otherwise), an instrument,
or a series or combination of agreements and instruments: (A) to make or take delivery of, or assume or relinquish, a
specified amount of one (1) or more of the interests underlying the derivative instrument, or to make a cash settlement in lieu
thereof; or (B) that has a price, performance, value, or cash flow based primarily upon the actual or expected price, level,
performance, value, or cash flow of one (1) or more of the interests underlying the derivative instrument. Derivative
instruments include options, warrants used in a hedging transaction and not attached to another financial instrument, caps,
floors, collars, swaps, swaptions, forwards, futures, and any other agreements (in the nature of bilateral contracts, options, or
otherwise) or substantially similar instruments, or any series or combination thereof, and any agreements (in the nature of
bilateral contracts, options, or otherwise) or instruments permitted under rules adopted by the department.
(14) “Derivative transaction” means a transaction involving the use of one (1) or more derivative instruments. For purposes
of this section, a derivative transaction may involve a requirement that the insurer, a counterparty, or both, are required to
post collateral with the other party (or a designated third party) pursuant to an agreement between the insurer and the
counterparty.
(15) “Domestic jurisdiction” means the United States, any state, territory, or possession of the United States, the District of
Columbia, Canada, or any province of Canada.
(16) “Floor” means an agreement obligating the seller to make payments to the buyer, with each payment based on the
amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price or level or the
performance or value of one or more underlying interests.
(17) “Foreign currency” means a currency other than that of a domestic jurisdiction.
(18) “Foreign jurisdiction” means a jurisdiction other than a domestic jurisdiction.
(19) “Forward” means an agreement (other than a future) to make or take delivery of, or effect a cash settlement based on the
actual or expected price, level, performance, or value of, one (1) or more underlying interests.
(20) “Future” means an agreement, traded on a qualified exchange or qualified foreign exchange, to make or take delivery of,
or effect a cash settlement based on the actual or expected price, level, performance, or value of, one or more underlying interests…
(23) “Hedging transaction” means a derivative transaction that is entered into and maintained to manage: (A) the risk of a
change in the value, yield, price, cash flow, or quantity of assets or liabilities (or a portfolio of assets, liabilities, or assets and
liabilities) that the insurer has acquired or incurred or anticipates acquiring or incurring; or (B) currency exchange rate risk or
the degree of exposure to assets or liabilities (or a portfolio of assets, liabilities, or assets and liabilities) that the insurer has
acquired or incurred or anticipates acquiring or incurring.
(24) “Income generation transaction” means a derivative transaction involving the writing of covered call options, covered
put options, covered caps, or covered floors.
(28) “Market value” means: (A) as to cash, cash equivalents, and letters of credit, the amounts thereof; (B) as to a security
(other than a security that is an over-the-counter derivative instrument) as of any date, the price for the security on that date
obtained from a generally recognized source or the most recent quotation from such a source or, to the extent no generally
recognized source exists, the price for the security as determined in good faith by the parties to a transaction, plus accrued but
unpaid income on the security to the extent not included in the price as of that date; and (C) as to an over-the-counter
derivative instrument as of any date, the amount that a life insurance company would have to pay or would receive for
entering into an over-the-counter derivative transaction on substantially identical terms with another counterparty.
(31) “Obligation” means any of the following: (A) A bond. (B) A note. (C) A debenture. (D) Any other form of evidence of
debt.
(32) “Option” means an agreement giving the buyer the right to buy or receive (a “call option”), sell or deliver (a “put
option”), enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, level, performance,
or value of one or more underlying interests.
(33) “Qualified business entity” means a business entity that is: (A) an issuer of obligations, preferred stock, or derivative
instruments that are rated 1 or 2 or are rated the equivalent of 1 or 2 by the Securities Valuation Office or by a nationally
recognized statistical rating organization recognized by the Securities Valuation Office; or (B) a primary dealer in United
States government securities, recognized by the Federal Reserve Bank of New York.
(34) “Qualified clearinghouse” means a clearinghouse: (A) that is for, and subject to the rules of, a qualified exchange or
qualified foreign exchange; and (B) that provides clearing services, including acting as a counterparty to each of the parties to
a transaction so that the parties no longer have credit risk as to each other.
(35) “Qualified exchange” means: (A) a securities exchange registered as a national securities exchange, or a securities
market regulated under the Securities Exchange Act of 1934 (15 U.S.C. 78 et seq.), as amended; (B) a board of trade or
commodities exchange designated as a contract market by the Commodity Futures Trading Commission (CFTC) or any
successor of the CFTC; (C) Private Offerings, Resales, and Trading through Automated Linkages (PORTAL); (D) a
designated offshore securities market as defined in Securities Exchange Commission Regulation S (17 C.F.R. Part 230), as
amended; or (E) a qualified foreign exchange.
(36) “Qualified foreign exchange” means a foreign exchange, board of trade, or contract market located outside the United States or its territories or possessions: (A) that has received regulatory comparability relief under CFTC Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s Regulations (17 C.F.R. Part 30)); (B) that is, or whose members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief under CFTC Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s Regulations (17 C.F.R. Part 30)) as to futures transactions in the jurisdiction where the exchange, board of trade, or contract market is located; or (C) upon which are listed foreign stock index futures contracts that are the subject of no-action relief issued by the CFTC’s Office of the General Counsel, provided that an exchange, board of trade, or contract market that qualifies as a qualified foreign exchange only under this clause is a qualified foreign exchange only as to foreign stock index futures contracts that are the subject of no-action relief.

(37) “Replication transaction” means a derivative transaction that is intended to replicate the investment in one (1) or more assets that an insurer is authorized to acquire or sell under this section or section 2 of this chapter. A derivative transaction that is entered into as a hedging transaction shall not be considered a replication transaction.

(38) “Swap” means an agreement to exchange or to net payments at one (1) or more times based on the actual or expected price, level, performance, or value of one (1) or more underlying interests.

(39) “Swaption” means an agreement giving the buyer the right (but not the obligation) to enter into a swap at a specified time in the future.

(40) “Underlying interest” means the assets, liabilities, other interests or a combination thereof underlying a derivative instrument, such as any one (1) or more securities, currencies, rates, indices, commodities, or derivative instruments.

(41) “Risk management” means a systematic procedure that is entered into as a hedging transaction shall not be considered a replication transaction.

(c) A life insurance company’s board of directors shall do all the following: (1) Before engaging in derivatives transactions, approve a written plan that specifies guidelines, systems, and objectives to be followed, such as: (A) investment or, if applicable, underwriting objectives and risk constraints, such as credit risk limits; (B) permissible transactions and the relationship of those transactions to the insurer’s operations; (C) internal control procedures; (D) a system for determining whether a derivative instrument used for hedging has been effective; (E) a credit risk management system for over-the-counter derivatives transactions that measures credit risk exposure using the counterparty exposure amount; and (F) a mechanism for reviewing and auditing compliance with the guidelines, systems, and objectives specified in the written plan.

(2) Before engaging in derivatives transactions, make a determination that the insurer’s investment managers have adequate professional personnel, technical expertise, and systems to implement the insurer’s intended investment practices involving derivative instruments.

(3) Review whether derivatives transactions have been made in accordance with the approved guidelines and are consistent with stated objectives.

(4) Take action to correct any deficiencies in internal controls relating to derivatives transactions.

(d) A life insurance company may use derivative instruments under this section to engage in hedging transactions, certain income generation transactions, and certain replication transactions, as these terms may be further defined in rules adopted by the department. For each hedging and replication transaction in which it engages, a life insurance company must be able to demonstrate to the commissioner: (1) the intended characteristics; and (2) the ongoing effectiveness; of the derivative transaction or combination of the derivatives transactions through appropriate analyses.

(e) A life insurance company may enter into the following types of income generation transactions: (1) sales of covered call options on: (A) non-callable fixed income securities; (B) callable fixed income securities if the option expires by its terms before the end of the noncallable period; or (C) derivative instruments based on fixed income securities or yields; (2) sales of covered call options on equity securities; (3) sales of covered puts on investments that the insurer is permitted to acquire under section 2 of this chapter; and (4) sales of covered caps or floors; only if, as a result of the transactions and after giving effect to the transactions, the aggregate statement value of the fixed income securities that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of the insurer’s admitted assets.

(f) A life insurance company may enter into replication transactions. For the purposes of this subsection, a replication
transaction is subject to the limitations and restrictions set forth in section 2 of this chapter to which the replicated investments are subject...

(h) A life insurance company shall include all counterparty exposure amounts in determining compliance with the limitations set forth in section 2(b)(21) of this chapter.

(i) Upon the request of a life insurance company, the commissioner may approve additional transactions involving the use of derivative instruments that: (1) exceed the limits set forth in subsections (d), (e), and (f); or (2) are for other risk management purposes.

(j) A life insurance company shall maintain documentation and records relating to each derivative transaction. The documentation and records must record and include matters such as the following: (1) The purpose or purposes of the transaction. (2) The assets or liabilities to which the transaction relates. (3) The specific derivative instrument used in the transaction. (4) For collateralized derivatives transactions, a description of any collateral posted by the insurer or the counterparty, as well as records documenting any subsequent variations in the amount of the collateral.

(k) For over-the-counter derivative transactions, the name of the counterparty and the counterparty exposure amount. (6) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

(k) Each derivative instrument shall be: (1) traded on a qualified exchange; (2) entered into with, or guaranteed by, a business entity; (3) issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or (4) entered into on a qualified foreign exchange.

IC 27-1-13-3 Investment of capital and funds above capital; power to acquire, hold, or convey real estate

(f) The board of directors of a company, other than a company organized as a life insurance company, shall do all the following: (1) Before engaging in derivatives transactions, approve a written plan that specifies guidelines, systems, and objectives to be followed, such as: (A) investment of or, if applicable, underwriting objectives and risk constraints, such as credit risk limits; (B) permissible transactions and the relationship of those transactions to the insurer’s operations; (C) internal control procedures; (D) a system for determining whether a derivative instrument used for hedging has been effective; (E) a credit risk management system for over-the-counter derivatives transactions that measures credit risk exposure using the counterparty exposure amount; and (F) a mechanism for reviewing and auditing compliance with the guidelines, systems, and objectives specified in the written plan. (2) Before engaging in derivatives transactions, make a determination that the insurer’s investment managers have adequate professional personnel, technical expertise, and systems to implement the insurer’s intended investment practices involving derivative instruments. (3) Review whether derivatives transactions have been made in accordance with the approved guidelines and are consistent with stated objectives. (4) Take action to correct any deficiencies in internal controls relating to derivatives transactions.

Assessment of the Investment Analysis Office

Model Act

Insurer may, directly or indirectly, engage in derivative transactions under following conditions:

A. General Conditions

(1) Hedging transactions and certain income generation transactions; YES includes replications

(2) Must demonstrate hedging characteristics and ongoing effectiveness; YES

B. Limitations on Hedging Transactions YES same as Model Act

Hedging permitted if, as a result of and after giving effect to the transaction:

(1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;

(2) ASV of options, caps and floors does not exceed 3% of admitted assets; and

(3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions – YES same as Model Act

ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:

(1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;

(2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;

(3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or

(4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.

D. Counterparty Exposure

Counterparty exposure amounts included when determining compliance with limitations. YES
E. Additional Transactions

Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes. YES

Model Regulation

Adopted and promulgated by the Commissioner of Insurance YES

Set standards for the prudent use of derivative instruments per Model Act. YES

Definitions YES

“Business entity”

“Counterparty exposure amount”:

“Derivative instrument” –

 Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or

 That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

 Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or any series or combination.

 Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”

“Qualified exchange”

“Qualified foreign exchange”

Guidelines and Internal Control Procedures

Written guidelines, YES approved by the Commissioner. No

Objectives for transactions & strategies & risk constraints, including credit risk limits specified; YES

Establishes counterparty exposure limits and credit quality standards YES

Identifies permissible transactions and relationship to insurer operations; YES

Requires compliance with internal control procedures. YES

Written methodology for determining hedging effectiveness. YES

Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk exposure using the counterparty exposure amount. YES

Board shall:

Approve written guidelines, methodology, policies & procedures & systems. YES

Determine insurer has adequate professional personnel, technical expertise & systems. YES

Review transactions made in accordance with approved guidelines and stated objectives. YES

Take action to correct any deficiencies in internal controls. YES

Written documentation submitted for approval. No

Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management. Not discussed

Documentation Requirements – YES same standards as in Model Regulation

Documentation & records for each transaction to contain:

Purpose of transaction;

The assets or liabilities to which the transaction relates;

Specific derivative instrument used in the transaction;

OTC name of counterparty and market value; and

Exchange traded name of exchange and of firm that handled trade and market value.

Trading Requirements Each derivative instrument: Same standards as in Model Regulation

Traded on a qualified exchange;

Entered into with, or guaranteed by, a business entity;

Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.

9. Arizona

A.R.S. § 20-560 - Derivative transactions; definitions

A. An insurer, directly or indirectly through an investment subsidiary, may use derivative instruments to engage in hedging transactions, income generation transactions and replication transactions pursuant to this section.

B. An insurer may enter into hedging transactions if, after giving effect to such transactions, all of the following apply: 1. The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one-half per cent of its admitted assets. 2. The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three per cent of its admitted assets. 3. The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half per cent of its admitted assets.

C. An insurer may enter into the following types of income generation transactions if after giving effect to the transactions the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments
under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus
the amount of the purchase obligations under the puts, does not exceed ten per cent of its admitted assets: 1. Sales of covered
call options on noncallable fixed income securities, callable fixed income securities if the option expires by its terms before
the end of the noncallable period or derivative instruments based on fixed income securities. 2. Sales of covered call options
on equity securities, if the insurer holds in its portfolio or can immediately acquire through the exercise of options, warrants
or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold. 3.
Sales of covered puts on investments that the insurer is permitted to acquire under this article, if the insurer has escrowed or
entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its
purchase obligations under the put during the complete term of the put option sold. 4. Sales of covered caps or floors, if the
insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors
during the complete term that the cap or floor is outstanding.

D. An insurer may enter into replication transactions with the prior written approval of the director if both of the following
apply 1. The insurer would otherwise be authorized to invest its funds under this article in the asset being replicated. 2. The
asset being replicated is subject to all the provisions of this article relating to the making of investments by the insurer in that
type of asset as if the transaction constituted a direct investment by the insurer in the replicated asset.

E. The director may approve of additional transactions involving the use of derivative instruments in excess of the limits of
subsection B of this section or for other risk management purposes, except that replication transactions shall be permitted
only for risk management purposes.

F. Each derivative instrument shall be one of the following: 1. Traded on a qualified exchange. 2. Entered into with or
guaranteed by a business entity. 3. Issued or written with the issuer of the underlying interest on which the derivative
instrument is based. 4. Entered into with a qualified foreign exchange.

G. For the purposes of this section, unless the context otherwise requires:

1. “Business entity” includes a sole proprietorship, corporation, limited liability company, association, partnership, joint
stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether
organized for-profit or not-for-profit.

2. “Cap” means an agreement obligating the seller to make payments to the buyer, with each payment based on the amount
by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined
number, sometimes called the strike rate or strike price.

3. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the
seller of a different option, cap or floor.

4. “Derivative instrument”: (a) Means an agreement, option or instrument or a series or combination that either:
(i) Requires a party to make or take delivery of, or assume or relinquish, a specified amount of one or more underlying
interests, or to make a cash settlement in lieu thereof. (ii) Has a price, performance, value or cash flow based primarily on the
actual or expected price, level, performance, value or cash flow of one or more underlying interests. (b) Includes options,
warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards,
futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof
and any agreements, options or instruments permitted under rules adopted to carry out the provisions of this article. (c) Does
not include an investment authorized by §§ 20-537 through 20-548, 20-550 through 20-558, 20-561 and 20-562.

5. “Derivative transaction” means a transaction involving the use of one or more derivative instruments.

6. “Floor” means an agreement obligating the seller to make payments to the buyer in which each payment is based on the
amount by which a predetermined number exceeds a reference price, level, performance or value of one or more underlying
interests.

7. “Forward” means an agreement, other than a future, to make or take delivery of, or effect a cash settlement based on the
actual or expected price, level, performance or value of, one or more underlying interests.

8. “Future” means an agreement, traded on a qualified exchange or qualified foreign exchange, to make or take delivery of,
or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more underlying
interests.

9. “Hedging transaction” means a derivative transaction that is entered into and maintained to reduce either: (a) The risk of a
change in the value, yield, price, cash flow or quantity of assets or liabilities that the insurer has acquired or incurred or
anticipates acquiring or incurring. (b) The currency exchange rate risk or the degree of exposure as to assets or liabilities that
an insurer has acquired or incurred or anticipates acquiring or incurring.

10. “Income generation transaction” means a derivative transaction involving the writing of covered call options, covered put
options, covered caps or covered floors that is intended to generate income or enhance return.

11. “Option” means an agreement giving the buyer the right to buy or receive, referred to as a “call option”, to sell or deliver,
referred to as a “put option”, to enter into, extend or terminate, or to effect a cash settlement based on the actual or expected
price, spread, level, performance or value of one or more underlying interests.
12. “Qualified exchange” means: (a) A securities exchange registered as a national securities exchange, or a securities market regulated under the securities exchange act of 1934, as amended. (b) A board of trade or commodities exchange designated as a contract market by the commodity futures trading commission or any successor thereof. (c) Private offerings, resales and trading through automated linkages. (d) A designated offshore securities market as defined in securities exchange commission regulations, 17 Code of Federal Regulations part 230, as amended. (e) A qualified foreign exchange.

13. “Qualified foreign exchange” means a foreign exchange, board of trade or contract market located outside the United States or its territories or possessions if one of the following applies: (a) The exchange, board of trade or contract market has received regulatory comparability relief under commodity futures trading commission rule 30.10, as set forth in appendix C to 17 Code of Federal Regulations part 30. (b) The exchange, board of trade or contract market is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief under commodity futures trading rule 30.10, as set forth appendix C to 17 Code of Federal Regulations, part 30, as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located. (c) Foreign stock index futures contracts are listed on the exchange, board of trade or contract market and the contracts are the subject of no-action relief issued by the commodity futures trading commission office of general counsel if the exchange, board of trade or contract market that qualifies as a qualified foreign exchange under this subdivision is a qualified foreign exchange only as to foreign stock index futures contracts that are the subject of no-action relief.

14. “Replication transaction”: (a) Means a derivative transaction that is intended to replicate the performance of one or more assets that an insurer is authorized to acquire under this article. (b) Does not include a derivative transaction that is entered into as a hedging transaction.

15. “Swap” means an agreement to exchange or to net payments at one or more times based on the actual or expected price, level, performance or value of one or more underlying interests.

16. “Underlying interest” means the assets, liabilities, other interests or a combination thereof underlying a derivative instrument, including any securities, currencies, rates, indices, commodities or derivative instruments.

17. “Warrant” means an instrument that gives the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, including as part of a merger or recapitalization agreement or to facilitate divestiture of the securities of another business entity.

Assessment of the Investment Analysis Office

Model Act

Insurer may, directly or indirectly, engage in derivative transactions under following conditions:

A. General Conditions

(1) Hedging transactions and certain income generation transactions; YES includes replications

(2) Must demonstrate hedging characteristics and ongoing effectiveness; YES

B. Limitations on Hedging Transactions YES same as Model Act

Hedging permitted if, as a result of and after giving effect to the transaction:

(1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;

(2) ASV of options, caps and floors does not exceed 3% of admitted assets; and

(3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions – YES same as Model Act

ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:

(1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;

(2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;

(3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or

(4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.

D. Counterparty Exposure

Counterparty exposure amounts included when determining compliance with limitations. YES

E. Additional Transactions

Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes. YES
Model Regulation
Adopted and promulgated by the Commissioner of Insurance
Set standards for the prudent use of derivative instruments per Model Act.
Definitions – Definitions are consistent with Models
“Business entity”
“Counterparty exposure amount”:
“Derivative instrument” –
  ▪ Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or
  ▪ That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
  ▪ Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or any series or combination.
  ▪ Include any agreement, options or instruments permitted under regs under Model Act.
“Qualified clearinghouse”
“Qualified exchange”
“Qualified foreign exchange”

Guidelines and Internal Control Procedures
No Mention
Written guidelines, approved by the Commissioner.
Objectives for transactions & strategies & risk constraints, including credit risk limits specified;
Establishes counterparty exposure limits and credit quality standards
Identifies permissible transactions and relationship to insurer operations;
Requires compliance with internal control procedures.
Written methodology for determining hedging effectiveness.
Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk exposure using the counterparty exposure amount.
Board shall: No mention
Approve written guidelines, methodology, policies & procedures & systems.
Determine insurer has adequate professional personnel, technical expertise & systems.
Review transactions made in accordance with approved guidelines and stated objectives.
Take action to correct any deficiencies in internal controls.
Written documentation submitted for approval.
Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management.

Documentation Requirements – No mention
Documentation & records for each transaction to contain:
Purpose of transaction;
The assets or liabilities to which the transaction relates;
Specific derivative instrument used in the transaction;
OTC name of counterparty and market value; and
Exchange traded name of exchange and of firm that handled trade and market value.

Trading Requirements Each derivative instrument: Same standards as in Model Regulation
Traded on a qualified exchange;
Entered into with, or guaranteed by, a business entity;
Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.
10. Nebraska

Neb. Rev. St. § 44-5149 - 44-5149. Hedging transactions; derivative instruments

(1) An insurer may use derivative instruments in hedging transactions if: (a) The aggregate statement value of options, caps, floors, and warrants not attached to any financial instrument and used in hedging transactions does not exceed the lesser of seven and one-half percent of the insurer’s admitted assets or seventy-five percent of the insurer’s policyholders surplus; (b) The aggregate statement value of options, caps, and floors written in hedging transactions does not exceed the lesser of three percent of the insurer’s admitted assets or thirty percent of the insurer’s policyholders surplus; and (c) The aggregate potential exposure of collars, swaps, forwards, and futures used in hedging transactions does not exceed the lesser of six and one-half percent of the insurer’s admitted assets or sixty-five percent of the insurer’s policyholders surplus.

(2)(a) An insurer may use derivative instruments in income-generation transactions by selling: (i) Covered call options on non-callable fixed income securities or callable fixed income securities if the option expires by its terms prior to the end of the non-callable period; (ii) Covered call options on equity securities if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants, or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold; (iii) Covered puts on investments that the insurer is permitted to acquire under the Insurers Investment Act if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under that put during the complete term of the put option sold; and (iv) Covered caps or floors if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under such caps or floors during the complete term that the cap or floor is outstanding. (b) An insurer may enter into income-generation transactions under this subsection if the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying any derivative instrument subject to call, does not exceed the lesser of ten percent of the insurer’s admitted assets or one hundred percent of the insurer’s policyholders surplus.

(3) An insurer may use derivative instruments in replication transactions if: (a) The aggregate statement value of options, caps, floors, and warrants not attached to any financial instrument and used in replication transactions does not exceed the lesser of seven and one-half percent of the insurer’s admitted assets or seventy-five percent of the insurer’s policyholders’ surplus; (b) The aggregate statement value of options, caps, and floors written in replication transactions does not exceed the lesser of three percent of the insurer’s admitted assets or thirty percent of the insurer’s policyholders’ surplus; (c) The aggregate potential exposure of collars, swaps, forwards, and futures used in replication transactions does not exceed the lesser of six and one-half percent of the insurer’s admitted assets or sixty-five percent of the insurer’s policyholders’ surplus; (d) The replication transactions are limited to the replication of investments or instruments otherwise permitted under the Insurers Investment Act; and (e) The insurer engages in hedging transactions or income generation transactions pursuant to this section and has sufficient experience with derivatives generally such that its performance and procedures reflect that the insurer has been successful in adequately identifying, measuring, monitoring, and limiting exposures associated with such transactions and that the insurer has superior corporate controls over such activities as well as a sufficient number of dedicated staff who are knowledgeable and skilled with these sophisticated financial instruments.

(4) An insurer may purchase or sell one or more derivative instruments to offset any derivative instrument previously purchased or sold, as the case may be, without regard to the quantitative limitations of this section, provided that the derivative instrument is an exact offset to the original derivative instrument being offset.

(5) An insurer shall demonstrate to the director upon request the intended hedging, income-generation, or replication characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analysis.

(6) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations in section 44-5115.

(7) The director may approve additional transactions involving the use of derivative instruments pursuant to rules and regulations adopted and promulgated by the director.

(8) For purposes of this section: (a) Derivative instrument means an agreement, option, instrument, or a series or combination thereof: (i) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests or to make a cash settlement in lieu thereof; or (ii) That has a price, performance, value, or cash flow based primarily upon the actual or expected price, level, performance, value, or cash flow of one or more underlying interests. Derivative instrument includes all investment instruments or contracts that derive all or almost all of their value from the performance of an underlying market, index, or financial instrument, including, but not limited to, options, warrants, caps, floors, collars, swaps, credit default swaps, swaptions, forwards, and futures. Derivative instrument does not include investments authorized under any other section of the Insurers Investment Act; (b) Hedging transaction means a derivative transaction which is entered into.
and maintained to reduce: (i) The risk of a change in value, yield, price, cash flow, or quantity of assets or liabilities which the insurer has acquired or incurred or anticipates acquiring or incurring; or (ii) The currency exchange rate risk or the degree of exposure as to assets or liabilities which an insurer has acquired or incurred or anticipates acquiring or incurring; (c) Income-generation transaction means a derivative transaction involving the writing of covered call options, covered put options, covered caps, or covered floors that is intended to generate income or enhance return; and (d) Replication transaction means a derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer’s portfolio in order to replicate the investment characteristic of another authorized transaction, investment, or instrument or that may operate as a substitute for cash market investments. A derivative transaction entered into by the insurer as a hedging or income-generation transaction authorized pursuant to this section shall not be considered a replication transaction.

Assessment of the Investment Analysis Office

Model Act
Insurer may, directly or indirectly, engage in derivative transactions under following conditions:

A. General Conditions
(1) Hedging transactions and certain income generation transactions; **YES**
(2) Must demonstrate hedging characteristics and ongoing effectiveness; **YES**

B. Limitations on Hedging Transactions **YES same as Model Act. Imposes same structure of Replications**
Hedging permitted if, as a result of and after giving effect to the transaction:
(1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;
(2) ASV of options, caps and floors does not exceed 3% of admitted assets; and
(3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.

C. Limitations on Income Generation Transactions – **YES same as in Model Act**
ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:
(1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative instruments based on FI securities;
(2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or conversion rights owned, the equity securities subject to call during the complete term of the call option sold;
(3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or
(4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors during term that the cap or floor is outstanding.

D. Counterparty Exposure
Counterparty exposure amounts included when determining compliance with limitations. **YES**

E. Additional Transactions
Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be permitted for other than risk management purposes. **YES**

Model Regulation
No mention
Adopted and promulgated by the Commissioner of Insurance
Set standards for the prudent use of derivative instruments per Model Act.

Definitions – **Consistent with Models**
“Business entity”
“Counterparty exposure amount”:
“Derivative instrument” –
- Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more underlying interests; make cash settlement; or
- That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
- Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or any series or combination.
- Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”
“Qualified exchange”
“Qualified foreign exchange”

Guidelines and Internal Control Procedures
General requirement that insurer have sufficient experience but no mention of Model Regulation standards
Written guidelines, approved by the Commissioner.
Objectives for transactions & strategies & risk constraints, including credit risk limits specified;
Establishes counterparty exposure limits and credit quality standards
Identifies permissible transactions and relationship to insurer operations;
Requires compliance with internal control procedures.
Written methodology for determining hedging effectiveness.
Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk exposure using the counterparty exposure amount.

Board shall:
No mention of Model Regulation standards
Approve written guidelines, methodology, policies & procedures & systems.
Determine insurer has adequate professional personnel, technical expertise & systems.
Review transactions made in accordance with approved guidelines and stated objectives.
Take action to correct any deficiencies in internal controls.
Written documentation submitted for approval.
Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management.

Documentation Requirements – No mention of Model Regulation Standards
Documentation & records for each transaction to contain:
Purpose of transaction;
The assets or liabilities to which the transaction relates;
Specific derivative instrument used in the transaction;
OTC name of counterparty and market value; and
Exchange traded name of exchange and of firm that handled trade and market value.

Trading Requirements No mention of Model Regulation Standards
Each derivative instrument:
Traded on a qualified exchange;
Entered into with, or guaranteed by, a business entity;
Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.
11. Texas

V.T.C.A., Insurance Code § 424.215 - Limitation on Sale of Call Option on Derivative Instrument

If an income generation transaction is a sale of a call option on a derivative instrument, including a swaption, the insurer must: (1) during the entire period the call option is outstanding, hold, or have a currently exercisable right to acquire, assets generating the cash flow necessary to make any payment for which the insurer is liable under the underlying derivative instrument; and (2) have the ability to enter into the underlying derivative transaction for the insurer’s portfolio.

V.T.C.A., Insurance Code § 424.201 - Definitions

In this subchapter:

(1) “Acceptable collateral” means: (A) cash; (B) cash equivalents; (C) letters of credit and direct obligations; or (D) securities that are fully guaranteed as to principal and interest by the United States.

(2) “Business entity” includes an association, bank, corporation, joint stock company, joint tenancy, joint venture, limited liability company, mutual fund, partnership, sole proprietorship, trust, or other similar form of business organization, regardless of whether organized for profit.

(3) “Cap” means an agreement obligating the seller to make payments to the buyer, with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number that is sometimes called the strike rate or strike price.

(4) “Cash equivalent” means an investment or security that is short-term, highly rated, highly liquid, and readily marketable. The term includes a money market fund described by Section 424.106. For purposes of this subdivision, an investment or security is (A) short-term if it has a remaining term to maturity of one year or less; and (B) highly rated if it has: (i) a rating of “P-1” by Moody’s Investors Service, Inc.; (ii) a rating of “A-1” by the Standard and Poor’s Division of the McGraw Hill Companies, Inc.; or (iii) an equivalent rating by a nationally recognized statistical rating organization recognized by the securities valuation office.

(5) “Collar” means an agreement to receive payments as the buyer of a cap, floor, or option and to make payments as the seller of a different cap, floor, or option.

(6)(A) “Counterparty exposure amount” means: (i) for an over-the-counter derivative instrument not entered into under a written master agreement that provides for netting of payments owed by the respective parties, the market value of the over-the-counter derivative instrument, if the liquidation of the derivative instrument would result in a final cash payment to the insurer, or zero, if the liquidation of the derivative instrument would not result in a final cash payment to the insurer; or (ii) for an over-the-counter derivative instrument entered into under a written master agreement that provides for netting of payments owed by the respective parties and for which the counterparty’s domiciliary jurisdiction is within the United States or a foreign jurisdiction listed in the Purposes and Procedures Manual of the securities valuation office as eligible for netting, the greater of zero or the net sum payable to the insurer in connection with all derivative instruments subject to the written master agreement on the liquidation of the instruments in the event of the counterparty’s default under the master agreement, if there is no condition precedent to the counterparty’s obligation to make the payment and if there is no setoff of amounts payable under another instrument or agreement. (B) For purposes of this subdivision, market value or the net sum payable, as applicable, must be determined at the end of the most recent quarter of the insurer’s fiscal year and must be reduced by the market value of acceptable collateral held by the insurer or a custodian on the insurer’s behalf.

(7) “Derivative instrument”: (A) means an agreement, option, or instrument, or a series or combination of agreements, options, or instruments: (i) to make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement instead of making or taking delivery of, or assuming or relinquishing, a specified amount of an underlying interest; or (ii) that has a price, performance, value, or cash flow based primarily on the actual or expected price, yield, level, performance, value, or cash flow of one or more underlying interests; (B) includes an option, a warrant not otherwise permitted to be held by the insurer under this subchapter, a cap, a floor, a collar, a swap, a swaption, a forward, a future, any other substantially similar agreement, option, or instrument, and a series or combination of those agreements, options, or instruments; and (C) does not include a collateralized mortgage obligation, another asset-backed security, a principal-protected structured security, a floating rate security, an instrument that an insurer would otherwise be authorized to invest in or receive under a provision of this subchapter other than this subdivision, or a debt obligation of the insurer.

(8) “Derivative transaction” means a transaction involving the use of one or more derivative instruments. The term does not include a dollar roll transaction, repurchase transaction, reverse repurchase transaction, or securities lending transaction.

(9) “Floor” means an agreement obligating the seller to make payments to the buyer, each of which is based on the amount by which a predetermined number that is sometimes called the floor price or floor rate exceeds a reference level, performance, price, or value of one or more underlying interests.

(10) “Forward” means an agreement to make or take delivery in the future of one or more underlying interests, or to effect a cash settlement, based on the actual or expected level, performance, price, or value of those interests. The term does not
include a future or a spot transaction effectuated within a customary settlement period, a when-issued purchase, or another similar cash market transaction.

(11) “Future” means an agreement traded on a futures exchange to make or take delivery of one or more underlying interests, or to effect a cash settlement, based on the actual or expected level, performance, price, or value of those interests.

(12) “Futures exchange” means a foreign or domestic exchange, contract market, or board of trade on which trading in futures is conducted and that, in the United States, is authorized to conduct that trading by the Commodity Futures Trading Commission or a successor to that agency.

(13) “Hedging transaction” means a derivative transaction entered into and maintained to manage, with respect to an asset, liability, or portfolio of assets or liabilities, that an insurer has acquired or incurred or anticipates acquiring or incurring: (A) the risk of a change in value, yield, price, cash flow, or quantity; or (B) the currency exchange rate risk.

(14) “Income generation transaction” means a derivative transaction entered into to generate income. The term does not include a hedging transaction or a replication transaction.

(15) “Market value” means the price for a security or derivative instrument obtained from a generally recognized source, the most recent quotation from a generally recognized source, or if a generally recognized source does not exist, the price determined under the terms of the instrument or in good faith by the insurer, as can be reasonably demonstrated to the commissioner on request, plus the amount of accrued but unpaid income on the security or instrument to the extent that amount is not included in the price as of the date the security or instrument is valued.

(16) “Option” means an agreement giving the buyer the right to buy or receive, referred to as a “call option,” to sell or deliver, referred to as a “put option,” to enter into, extend, or terminate, or to effect a cash settlement based on the actual or expected level, performance, price, spread, or value of, one or more underlying interests.

(17) “Over-the-counter derivative instrument” means a derivative instrument entered into with a business entity in a manner other than through a securities exchange or futures exchange or cleared through a qualified clearinghouse. (18) “Potential exposure” means: (A) as to a futures position, the amount of initial margin required for that position; or (B) as to a swap, collar, or forward, one-half of one percent multiplied by the notional amount multiplied by the square root of the remaining years to maturity.

(19) “Qualified clearinghouse” means a clearinghouse that: (A) is subject to the rules of a securities exchange or a futures exchange; and (B) provides clearing services, including acting as a counterparty to each of the parties to a transaction in a manner that eliminates the parties’ credit risk to each other.

(20) “Replication transaction” means a derivative transaction or a combination of derivative transactions effectuated separately or in conjunction with cash market investments included in the insurer’s investment portfolio to replicate the risks and returns of another authorized transaction, investment, or instrument or to operate as a substitute for cash market transactions. The term does not include a hedging transaction.

(21) “Securities exchange” means: (A) an exchange registered as a national securities exchange or a securities market registered under the Securities Exchange Act of 1934 (15 U.S.C. Section 78a et seq.), as amended; (B) the Private Offerings, Resales and Trading through Automated Linkages system; or (C) a designated offshore securities market as defined by 17 C.F.R. Section 230.902, as amended.

(22) “Swap” means an agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance, or value of one or more underlying interests.

(23) “Swaption” means an option to purchase or sell a swap at a given price and time or at a series of prices and times. The term does not include a swap with an embedded option.

(24) “Underlying interest” means an asset, liability, or other interest underlying a derivative instrument or a combination of those assets, liabilities, or interests. The term includes a security, currency, rate, index, commodity, or derivative instrument.

(25) “Warrant” means an instrument under which the holder has the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times stated in the warrant.

V.T.C.A., Insurance Code § 424.204 - 424.204. Trading Requirements for Derivative Instruments

Each derivative instrument must be: (1) traded on a securities exchange; (2) entered into with, or guaranteed by, a business entity; (3) issued or written by, or entered into with, the issuer of the underlying interest on which the derivative instrument is based; or (4) in the case of futures, traded through a broker who is: (A) registered as a futures commission merchant under the Commodity Exchange Act (7 U.S.C. Section 1 et seq.), as amended; or (B) exempt from that registration under 17 C.F.R. Section 30.10, adopted under the Commodity Exchange Act (7 U.S.C. Section 1 et seq.), as amended.

V.T.C.A., Insurance Code § 424.205 - Derivative Use Plan

(a) Before an insurer enters into a derivative transaction, the insurer’s board of directors must approve a derivative use plan as part of the insurer’s investment plan otherwise required by law. (b) The derivative use plan must: (1) describe investment objectives and risk constraints, such as counterparty exposure amounts; (2) define permissible transactions, identifying the risks to be hedged and the assets or liabilities being replicated; and (3) require compliance with the insurer’s internal control procedures established under Section 424.206.
An insurer that enters into a derivative transaction shall establish written internal control procedures that require:
(1) a quarterly report to the board of directors that reviews: (A) each derivative transaction entered into, outstanding, or
closed out; (B) the results and effectiveness of the derivatives program; and (C) the credit risk exposure to each counterparty
for over-the-counter derivative transactions based on the counterparty exposure amount;
(2) a system for determining whether hedging or replication strategies used by the insurer have been effective;
(3) a system of reports, at least as frequent as monthly, to the insurer’s management, that include: (A) a description of each
derivative transaction entered into, outstanding, or closed out during the period since the last report; (B) the purpose of each
outstanding derivative transaction; (C) a performance review of the derivative instrument program; and (D) the counterparty
exposure amount for each over-the-counter derivative transaction;
(4) a written authorization that identifies the responsibilities and limitations of authority of each person authorized to effect
and maintain derivative transactions; and
(5) appropriate documentation for each transaction, including: (A) the purpose of the transaction; (B) the assets or liabilities
to which the transaction relates; (C) the specific derivative instrument used in the transaction; (D) for an over-the-counter
derivative transaction, the name of the counterparty and the counterparty exposure amount; and (E) for an exchange-traded
derivative instrument, the name of the exchange and the name of the firm that handled the transaction.

Assessment of the Investment Analysis Office

2. Model Act
Insurer may, directly or indirectly, engage in derivative transactions under following conditions:
A. General Conditions
(1) Hedging transactions and certain income generation transactions; YES also mentions replications
(2) Must demonstrate hedging characteristics and ongoing effectiveness; YES
B. Limitations on Hedging Transactions No
   Hedging permitted if, as a result of and after giving effect to the transaction:
   (1) Aggregate statement value (ASV) of options, caps, floors and warrants does not exceed 7.5% of admitted assets;
   (2) ASV of options, caps and floors does not exceed 3% of admitted assets; and
   (3) Aggregate potential exposure collars, swaps, forwards & futures does not exceed 6.5% of admitted assets.
C. Limitations on Income Generation Transactions – No
   ASV of fixed income (FI) subject to call; generating cash flows for payments under caps or floors; face value of FI underlying a derivative
   subject to call plus amount of purchase obligations under puts, does not exceed 10% of admitted assets:
   (1) Sales of covered call options on non-callable FI securities, callable FI securities if option expires prior to end of noncallable period or derivative
       instruments based on FI securities;
   (2) Sales of covered call options on equity securities, if insurer holds in portfolio, or can immediately acquire through exercise of options, warrants or
       conversion rights owned, the equity securities subject to call during the complete term of the call option sold;
   (3) Sales of covered puts on investments insurer is permitted under Act, if insurer escrowed, or entered segregated in custodial agreement, cash or
       cash equivalents with market value equal to the amount of its purchase obligations under the put term of the put option sold; or
   (4) Sales of covered caps or floors, if insurer holds in portfolio investments generating the cash flow to make required payments under caps or floors
       during term that the cap or floor is outstanding.
D. Counterparty Exposure
   Counterparty exposure amounts included when determining compliance with limitations. Not mentioned
E. Additional Transactions
   Commissioner may approve derivatives use in excess of Subsection B limits or for risk management but replication transactions shall not be
   permitted for other than risk management purposes. Not mentioned

Model Regulation
Adopted and promulgated by the Commissioner of Insurance No mention
Set standards for the prudent use of derivative instruments per Model Act. No Definitions –
"Business entity"
"Counterparty exposure amount":
"Derivative instrument" – Same or similar to Models
- Agreement, option, instrument or series or combination: To make, take delivery of, assume or relinquish, a specified amount of one or more
  underlying interests; make cash settlement; or
- That has price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one
  or more underlying interests.
- Include options, warrants, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar or
  any series or combination.

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• Include any agreement, options or instruments permitted under regs under Model Act.

“Qualified clearinghouse”
“Qualified exchange”
“Qualified foreign exchange”

Guidelines and Internal Control Procedures
Written guidelines, Board must approve a derivatives use plan (approved by the Commissioner) No.
Objectives for transactions & strategies & risk constraints, including credit risk limits specified; YES
Establishes counterparty exposure limits and credit quality standards YES
Identifies permissible transactions and relationship to insurer operations;
Requires compliance with internal control procedures. YES
Written methodology for determining hedging effectiveness. YES reporting required
Written policies & procedures describing credit risk management process & system for OTC transactions that measure credit risk exposure using the counterparty exposure amount.

Board shall:
Approve written guidelines, methodology, policies & procedures & systems. YES
Determine insurer has adequate professional personnel, technical expertise & systems. YES
Review transactions made in accordance with approved guidelines and stated objectives. YES
Take action to correct any deficiencies in internal controls. YES
Written documentation submitted for approval. No
Commissioner may disapprove if insurer cannot demonstrate adequacy re risk management. Not discussed

Documentation Requirements – YES
Documentation & records for each transaction to contain: YES
Purpose of transaction; YES
The assets or liabilities to which the transaction relates; YES
Specific derivative instrument used in the transaction; YES
OTC name of counterparty and market value; and YES
Exchange traded name of exchange and of firm that handled trade and market value. YES

Trading Requirements Yes contains all Model Regulation standards
Each derivative instrument:
Traded on a qualified exchange;
Entered into with, or guaranteed by, a business entity;
Issued or written with issuer of underlying interest on which derivative instrument is based; or entered into with a qualified foreign exchange.
1. **Introduction** – This memorandum is intended to provide a summary of core concepts and facts to assist the members of the Task Force as they begin an assessment of insurer derivative activity in connection with the project to review the NAIC Derivatives Instrument Model Regulation (No. 282).

2. **Staff Report**

   a. **Derivatives as Investment Strategies** - Insurance companies use derivatives to implement investment and portfolio strategies. There are three allowed uses for derivatives under the various state investment laws, though most allow a small basket for other uses. Insurance companies generally use derivatives for hedging, replicating assets and generating income. Hedging—or managing and mitigating a variety of risks—is the primary use of derivatives. Examples of risks that are hedged by insurance companies include interest rate risk, credit risk, currency risk and equity-related risk. Replication is a derivative transaction that is entered into in conjunction with other investments in order to reproduce, either fully or in part, the investment characteristics of otherwise permissible investments. Income generation involves selling a derivative to generate additional income or return.

   b. **The Population** - Approximately 250 insurance companies participate in the derivatives market— with life companies and P/C companies representing 55% and 40%, respectively. Health and fraternal companies are not active participants in the derivatives market and represent a fraction of the industry’s exposure. Title companies do not utilize derivatives in their investment strategies.

   c. **Total Reported Exposure** - As of year-end 2014, the insurance industry’s derivatives exposure totaled $2.0 trillion in notional value, an 8.6% increase compared to year-end 2013. Life companies represent the majority, or 94%, of this exposure, and hedging accounts for 94% of the industry’s derivative use. Approximately 53% of the insurance industry’s derivatives exposure is used to hedge interest rate risk, with another 23% used to hedge equity-related risk. Note that although the market typically refers to notional values when referring to derivatives, it does not necessarily indicate the true economic exposure that an insurance company might face. Market value provides a more meaningful measure of amounts at risk, and for year-end 2014, the market value of the insurance industry’s derivatives exposure was $32 billion.
Table 1: U.S. Insurance Industry’s Derivatives Exposure as of YE 2014 (Notional Value $ in millions)

<table>
<thead>
<tr>
<th>Industry Segment</th>
<th>Hedging</th>
<th>Replication</th>
<th>Income Generation</th>
<th>Other</th>
<th>Total Notional Value</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life</td>
<td>1,811,583</td>
<td>31,570</td>
<td>3,990</td>
<td>42,775</td>
<td>1,890,018</td>
<td>54%</td>
</tr>
<tr>
<td>P/C</td>
<td>73,031</td>
<td>588</td>
<td>75</td>
<td>50,152</td>
<td>123,946</td>
<td>6%</td>
</tr>
<tr>
<td>Health</td>
<td>436</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>436</td>
<td>0%</td>
</tr>
<tr>
<td>Fraternal</td>
<td>268</td>
<td>0</td>
<td>375</td>
<td>-</td>
<td>643</td>
<td>0%</td>
</tr>
<tr>
<td>Total (Smil)</td>
<td>1,005,318</td>
<td>32,359</td>
<td>4,440</td>
<td>92,927</td>
<td>2,015,044</td>
<td>100%</td>
</tr>
<tr>
<td>% of Total</td>
<td>94%</td>
<td>2%</td>
<td>0%</td>
<td>5%</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

d. **Counterparty Risk** - Insurance companies face counterparty risk—the risk faced by one party that the other party to an agreement will not satisfy the obligations of the contract—primarily when entering into derivatives contracts that are traded over-the-counter, such as options, swaps and forwards. Large financial institutions such as Citigroup, Deutsche Bank, Goldman Sachs, Bank of America, and Credit Suisse are the most common counterparties in the derivatives market. However, in an effort to reduce systemic risks, the Dodd-Frank Wall Street Reform and Consumer Protection Act will require the majority of derivatives to be either traded on an exchange or cleared through a central clearinghouse. It is expected that there will be a small number of designated central clearinghouses that will be expected to be managed in a risk-neutral manner by having strict rules on margin, or collateral, requirements. Counterparty risk still exists for derivatives that are traded through exchanges and cleared through a central clearinghouse, but is considered to be relatively minimal.

e. **Oversight** - From the standpoint of state insurance regulation, there are a number of components that are central to the oversight of derivatives use by insurers. The NAIC Derivative Instruments Model Regulation (#282) sets standards for the prudent use of derivative instruments by insurance companies. It requires insurance companies to establish written guidelines for transacting in derivative instruments. Internal control procedures must also be outlined describing elements such as the monitoring of derivative positions and the credit risk management process. These guidelines and procedures are typically set forth in a derivatives use plan. Another key component is derivatives use laws, which can vary from state to state—some are extremely limiting, not only in the permitted uses of derivatives, but also in the individual and aggregate exposures allowed; others allow for some greater flexibility, including allowance under certain basket provisions. And finally, statutory accounting requires a detailed reporting of derivatives transactions and open positions.

f. **The Broader Context** - According to the Bank of International Settlements, the notional amount of outstanding over-the-counter derivatives contracts totaled $630 trillion. While the insurance industry’s use of derivatives is small compared with the overall size of the derivatives market, it is an important part of the industry’s strategy for managing and reducing risk. These transactions can be either for specific investments and products, or on a portfolio-wide basis, but, in any case, are components of an overall asset-liability management structure.
MEMORANDUM

TO: Stewart Guerin, Chair, Valuation of Securities (E) Task Force
   Members of the Valuation of Securities (E) Task Force

FROM: Bob Carcano, Senior Counsel, NAIC Investment Analysis Office

CC: Charles Therriault, Director, NAIC Securities Valuation Office

DATE: January 13, 2015

RE: Discussion – Improvements to NAIC Systems and Rules Governing Insurer Filing of Securities with the SVO

1. Introduction – The SVO is engaged in a wholesale review of its electronic computer system needs and related processes that aim at enhancing the ability of the office to provide high-quality and timely credit and valuation assessments to insurers for securities filed with the SVO. The internal evaluation of SVO computer needs necessarily involves an assessment of the rules set by the Task Force that govern filing of securities because it is necessary to embed the logic of the rules into such systems or into system processes. The filing rules discussed in this memorandum were adopted approximately 20 years ago and designed to function in an environment dominated by physical manipulation of paper documentation. Since the rules discussed herein were adopted, the regulatory filing and reporting process has evolved into a predominantly electronic process. This memorandum identifies the framework of filing rules and how they interact and makes preliminary observations about modifying or eliminating the components of the framework. The SVO believes that a reevaluation of current rules by the Task Force at this time could lead to significant efficiencies to the regulatory process and help increase the NAIC’s ability to support this regulatory process.

2. Background – As a fundamental concept, the SVO can only assess securities when they are filed with the SVO by insurers. Insurers file initial acquisitions and, in subsequent years, they file annual updates. In any year, and as a historical pattern, insurers file annual updates of securities at very low levels from (approximately) January to May. The number of annual update filings

![Filings' Fiscal Year End](image-url)
spikes and then increases significantly in the period beginning June through August. The annual update pattern appears completely unrelated to the fiscal year-end of the issuer as the percentage of annual updates filings for all issuer fiscal year-ends peak in the same months. (See Figure One, Figure Two and Figure Three). This pattern of filing virtually guarantees that SVO resources are under-utilized for a significant time period in any year and then put under tremendous stress for the remainder of the year. The most likely outcome of this pattern is a population of securities technically filed in a given year but not analyzed by the SVO nor assigned an NAIC Designation by year-end.

The only way, really, to ensure a reduction in the number of un-assessed securities at year-end is to change the policies related to the filing deadlines. The goal would be to eliminate both the annual update “wave” described above and to reduce the very lengthy period permitted after a security is acquired to make an initial filing. By altering both deadlines, the SVO staff resources could be better utilized to ensure a high-quality, reliable and timely regulatory product.

The large size of the sample is the annual update. The admissible evidence indicates that among any given population of insurers who own a given security, the insurers wait for someone else to file. One way to reduce the flood of filings shown in Figure One is to require insurers to file owned securities for annual updates shortly after the obligor’s financial statements become available. The second issue would be to more precisely identify the insurer that should file new purchases of securities and reduce the permitted filing window.

3. Preliminary Observations – The rules that govern filing today were developed approximately 20 years ago when filing occurred in a paper environment and relied on paper-based processes. While the NAIC and industry have made significant strides toward the development of an electronic filing environment, the filing rules have not been modified since they were initially adopted. What follows is a series of observations to facilitate a discussion on how the process that governs the filing of securities with the SVO can be improved. *We emphasize that SVO systems are already designed to prevent multiple filings of a given security, which means only one insurer is required to file any given security and all insurers who own that security can utilize the SVO work product*. The observations in this section are based on the discussion in Section 4 and Section 5 below.
All of the rules and processes that govern the filing process should be integrated into a single Part of the Purposes and Procedures Manual solely devoted to operational issues. This would increase an understanding of Task Force policies and of the application and operation of the rules.

The 120-Day Rule (which requires filing of newly acquired securities within that time period) should be shortened and the text reworded to communicate that securities be filed not more than 30 days after purchase.

The Purposes and Procedures Manual provides that the initial filer of a security is assumed to be the one responsible for filing an annual update. The word “assumed” probably reflects that the initial filer may at some time no longer own the security. The text should be expressed as a requirement. SVO systems can identify this insurer and the time period when its report is due. The SVO should be authorized to designate an insurer who continues to own the security as the “Filer of Record,” the one responsible for filing it in successive periods.

The period of time given to an insurer to file documents with the SVO under the Authorization to File (ATF) process could be eliminated. Instead, insurers would only be considered as having filed an ATF after all required documents had been received and the filing formally “Accepted” through an acknowledgment from the SVO.

Insurers rarely submit Material Credit Event Filings. The SVO monitoring function could be enhanced by modifying appropriate Statement of Statutory Accounting Principles (SSAPs) to require that the insurer demonstrate that the security was filed with the SVO for evaluation as part of the statutory reporting process pertaining to impairment and related accounting processes. The SVO can coordinate analysis with the affected state(s).

The use of the NR (not rated) and UP (unable to price) administrative symbols could be expanded. The symbols would be assigned to securities when the assigned insurer has not filed the annual update information in the required time period. The SVO would generate and publish lists of NR securities throughout the year so insurers that own the identified securities can file information for them. This would ensure that only those securities that no insurer filed for would remain on the list at year-end.

The Z symbol and process is intended for use at year-end by an insurer that has filed all necessary documentation within 120 days but not received a reply from the SVO by year-end. The Z symbol could instead be assigned by the SVO as part of its year-end process to identify securities the SVO has received in compliance with the filing policies but has not completed its analysis during the year-end process and which the SVO is committed to complete thereafter and disseminate in its Code 99 process.

The portion of the 5*/6* (pronounced “five star six star”) Rule that permits insurers to file certification for securities for which they lack documentation necessary for the SVO to assign an NAIC Designation should be reviewed for relevancy or eliminated.

4. Outline of the Current Operational Framework for Filing Securities with the SVO

a. Filing Requirement – Insurance companies are required to report investments to their state insurance departments with NAIC Designations and or Unit Prices. The core reporting instruction is that insurers obtain the NAIC Designations and Unit Prices from the SVO. This instruction is subsequently narrowed by a number of exemptions from filing. The exemptions exempt filing with the SVO but do not exempt from the requirement that the insurer obtain and report an NAIC Designation and Unit Price (Part Two, Section 2 (a) and (d), respectively).

b. The 120-Day Rule – An insurer is required to file securities subject to filing with the SVO within 120 days of the purchase of the security (Part Two, Section 7).

c. Who Files – Responsibility for filing a security with the SVO resides with the purchaser. As a general rule, the insurer with the largest dollar investment in a privately placed security is responsible for an initial filing (Part Two, Section 2 (d)), while an annual update is the responsibility of the initial filer (Part Two, Section 11 (a) (ii)).

d. Preventing Duplicative Filings – SVO systems are designed to prevent multiple filings of a given security. An insurer that wants to file a security with the SVO will link up to the Integrated Securities Information System (ISIS) component of the VOS Database and request an electronic ATF. When the insurer identifies the CUSIP number for the security, ISIS will search the Valuation of Securities (VOS) Database, the Filing Exempt (FE) Data File and Inquiry Service for the CUSIP.
i. **CUSIP in VOS** – If ISIS finds the CUSIP in the VOS Database with a current year review date, it will deny the ATF request and display a message that the CUSIP/PPN/CINS already exists in VOS. In this case, no other insurer need file the security, and every insurer that owns the security can use the designation and Unit Price shown in the system.

ii. **CUSIP in FE data file** – If the CUSIP/PPN/CINS identifier is not in the VOS Database but is in the FE Data File, ISIS will display a message that the security is FE.

iii. **CUSIP in Inquiry Service** - If the CUSIP/PPN/CINS identifier is not in the VOS Database or the FE Data File but is in Inquiry Service, it means another insurer has already filed an ATF. ISIS will deny the second request to file and display a message that an ATF number has been issued or an ATF filing has been received.

iv. **ISIS Issues ATF** – If the CUSIP is not in the VOS Database, the FE Data File or in Inquiry Service, ISIS will authorize the insurer to file by granting an ATF number (Part Two Sections 2 (d) and 6).

e. **Managing the ATF** – Once an ATF number has been issued, Inquiry Service will display the CUSIP/PPN/CINS identifier, ATF number and the date of ATF expiration or the date the SVO received the ATF submission.

i. **Exclusive Time Period** – An ATF gives the insurer an exclusive 30-day period to file the completed ATF form and required documentation with the SVO. If the ATF submission is not received at the SVO by the end of the 30-day period, ISIS deletes the CUSIP/PPN/CINS identifier from Inquiry, which permits another insurer to file for an ATF (Part Two Section 2 (d) and 6).

ii. **InfoReq** – Once the ATF form and documents are received, the SVO will assess the filing for sufficiency and log an InfoReq into Work Flow with a copy to the insurer. A security subject to InfoReq is held without processing for a period not to exceed 45 days. On an exception basis, the SVO may grant an InfoReq response extension to the reporting insurance company but not to exceed 90 days in total, with the time period to begin on the date that the InfoReq was issued. If, at the completion of the 45 days, the reporting insurance company has failed to provide the information requested, the SVO will discard the filing, and all documentation submitted with it and Work Flow will reflect that the filing was discarded due to insufficient information (Part Two, Section 10 (b)).

f. **Credit Assessment and Compilation** – A security filed with the SVO with all required documentation within 120 days of purchase will be designated for credit quality and entered into the VOS Database (Part One, Section 3 (f)) and published as part of the next quarterly compilation of insurer-owned securities (Part One, Section 3 (g)).

g. **Credit Surveillance Functions**

i. **Monitoring** – Once the security has been entered into the VOS Database, it is subject to monitoring by the SVO to permit evaluation of significant financial development affecting the issuer or the security and ensure an accurate designation. (Part One Section 3 (h) (i) (A)) To support this SVO function, insurers are required to file a Material Credit Events Filing, which consists of all information that indicates a change in the credit characteristics of the issuer or a material change in the terms of the agreement (Part Two, Section 11 (b)).

ii. **Annual Update** – Once the security has been entered into the VOS Database, it is also subject to a complete review on at least an annual basis to ensure the assigned designation is accurate (Part One, Section 11 (b)). To support this SVO function, any insurance company that owns a security listed in the VOS Database is invited to satisfy subsequent reporting requirements by filing the additional or annual information. The **Purposes and Procedures Manual** provides that the company that has filed the Initial Report is responsible for the annual update filing. But any insurance companies with an interest in a security must submit the information necessary to enable the SVO to complete its annual review (Part Two, Section 11 (a) (iii)).

iii. **Database Integrity** – The SVO is also instructed to delete from the VOS Database any security that has matured or for which there is a lack of sufficient or timely information (Part One, Section 3 (h) (ii)). SVO systems are programed to
identify securities subject to annual review for which required information has not been submitted. Bonds are assigned the administrative symbol NR, and preferred and common are assigned the administrative symbol UP. An NR or UP security for which required information is not provided by the end of the first quarter following a year-end are deleted from SVO systems.

5. The Special Reporting Instruction

a. 120-Day Rule and Year-End – An insurer must report a security within 120 days of purchase. The expectation appears to be that the security is reported within this time (not at the conclusion of it) and that the SVO is able to assess the credit quality of the security within the time frame. However, insurers are permitted to self-designate securities provided they comply with the 120-day rule reflecting a concern that during year-end an insurer may not both obtain and file necessary documentation and obtain an NAIC Designation from the SVO (Part One, Section 3 (b) (vi)).

b. The Z Process and the 120-Day Rule – Any security that an insurer self designates must be identified with the administrative symbol Z as a suffix to the designation. The administrative symbol Z communicates that the NAIC Designation reported by the insurance company was determined by the insurer, not the SVO. The use of this symbol is predicated on the assumption that the security designated with a Z will be submitted to the SVO within 120 days of the date the security was acquired. The Z symbol is not used for securities exempt from filing on the basis of credit rating provider (CRP) credit ratings (FE securities) (Part One, Section 3 (b) (v)).

c. The 5*/6* Process – The Special Instruction was originally designed to curtail improper use of the Z symbol. It was thought that requiring the assignment of an NAIC 5/6 equivalent to securities not filed with audited financial statements would help keep the use of the Z symbol as a temporary device used to handle the year-end issue discussed above. If the SVO is assigned responsibility for assigning the Z symbol the original purposes for the 5*/6* mechanism would be eliminated. The Task Force may wish to consider whether the Rule or the text describing it should be modified.
Attachment One

Part One – Purposes, General Policies and Instructions to the SVO

Section 3. Internal Administration

a) General

The staff of the SVO shall be organized in a manner that the NAIC Executive Vice President shall deem to be the most appropriate and efficient for the conduct of day-to-day credit assessment and valuation operations, consistent with the resources provided to the office by the NAIC. The staff shall promulgate such internal administrative procedures, protocols, policies and guidelines, as it shall deem necessary for the proper execution of its delegated functions. Such procedures, protocols, policies and guidelines as are promulgated by the staff shall be open to review and oversight by the.

b) Definitions of NAIC Designation Categories, Valuation Indicators, Administrative Symbols and Conventions

(i) SVO Administrative Symbols

SVO administrative symbols convey information about a security or an administrative procedure instead of an opinion of credit quality or Unit Price. The administrative symbols in use by the SVO and their meanings are described below.

(A) SVO analytical department symbols (except for the SVO SCA Companies Group)

All SVO analytical departments except the SVO SCA Companies Group use the following administrative symbols:

A means that the Unit Price of the share of common or preferred stock has been analytically determined by the SVO when used in context of an analytical department other than the SCA Companies Group.

V when used to report a Unit Price for common or preferred stock means the Unit Price reported was not provided by the SVO or any market or exchange but was derived by the insurance company itself or from some other source, pending a valuation analysis by the SVO.

L indicates that the Unit Price given for a share of common or preferred stock is the price listed on the New York Stock Exchange, the American Stock Exchange or on the NASDAQ National Market System.

U indicates that the price given for a share of common or preferred stock is the price listed on any market or exchange, including a foreign exchange, other than the New York Stock Exchange, the American Stock Exchange or the NASDAQ National Market System.

NOTE: The Administrative Symbols A, L, U and V which identify the manner or source of a Unit Price assigned by the SVO, are collectively referred to as Market Indicators in the NAIC Annual Statement Instructions.

UP means unable to price. This symbol is used with common or preferred stock and indicates that a current market quotation was not obtainable or was not deemed reliable by the SVO.
F means that the NAIC Designation, Unit Price or both shown was determined by the reporting insurance company and not by the SVO. Unlike the administrative symbol Z, the F symbol is used by insurers that meet the definitional criteria for a “Sub-paragraph D Company” as defined in Part Three, Section 1(a)(ii)(D)(4) of this Manual, to report ownership of a foreign security for which the company did not have the information necessary to permit the SVO to conduct an assessment or a valuation.

FE means exempt from filing with the SVO and is used by an insurance company to report an NAIC Designation for an exempt security on the NAIC Financial Statement Blank. When reporting a security on its annual or quarterly financial statements, the administrative symbol FE is used with an NAIC 1 through 6 Designation, and in addition, in the case of preferred stock, in combination with the P and RP Valuation Indicators. FE signifies that the reported security meets the criteria set forth in Part Two, Section 4(d) of this Manual and that the NAIC Designation was arrived at by the insurer by converting the NAIC CRP rating(s) into a corresponding NAIC Designation in accordance with the conversion instructions set forth in Part Two, Section 4(d)(i)(A) and (B) of this Manual and the rating equivalency identified in Section 7(d)(ii) of this Part or by the NAIC in comparing the security with the NAIC CRP rating feeds.

NR means Not Rated. The symbol is used in the VOS Products for bonds and communicates that the information required to arrive at an NAIC Designation is not available to the SVO or that such information was received too late to be processed and reflected in the most current VOS Products. Bonds assigned an NR symbol will be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end.

Z means that the NAIC Designation reported by the insurance company was not derived by or obtained from the SVO, but has been determined analytically by a reporting insurance company. A security designated with a Z must be submitted to the SVO for valuation within 120 days of the date the security was acquired. The Z symbol should not be used for securities that are exempt from filing with the SVO pursuant to Part Two, Section 4(d) of this Manual.

NR* indicates that the security so designated belongs to a class of securities currently under policy review by the NAIC.

Z* follows an NAIC Designation and means that the class of securities cannot be rated by the SVO because the valuation procedure is under regulatory review.

h) Monitoring of VOS Database
(ii) **Annual Review**

On at least an annual basis, the SVO shall review all NAIC Designations and Unit Prices assigned by the SVO to securities in the VOS Database in light of the information presented by each issuer's most recent Audited Financial Statements, or other pertinent information, to verify that the assigned NAIC Designation and/or Unit Price is accurate. As necessary, the SVO shall modify such NAIC Designation and/or Unit Price for the previously reported security as changed circumstances may require or delete any security that has matured or as to which there is a lack of sufficient or timely information.

Bonds assigned the administrative symbol **NR** shall be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end: provided, however, the SVO will not delete any Bond assigned the administrative symbol **NR** from the VOS Database if an ATF annual update filing for the Bond appears in ISIS and the SVO has received the necessary information required to assign an NAIC Designation to the Bond. If a Bond is not deleted in accordance with the foregoing process in reliance on an annual update ATF that does not contain the necessary information to permit the assignment of an NAIC Designation, the SVO shall subsequently delete that security from the database.

Preferred stock assigned the administrative symbol **UP** shall be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end: provided, however, the SVO will not delete any preferred stock assigned the administrative symbol **UP** from the VOS Database if an ATF annual update filing for the Bond appears in ISIS and the SVO has received the necessary information required to assign an NAIC Designation to the preferred stock. If a preferred stock is not deleted in accordance with the foregoing process in reliance on an annual update ATF that does not contain the necessary information to permit the assignment of a valuation and/or NAIC Designation, the SVO shall subsequently delete that security from the database.

Common stock assigned the administrative symbol **UP** shall be deleted from the VOS Database if any information deficiency is not rectified by the end of the first quarter following the previous year-end: provided, however, the SVO will not delete any common stock assigned the administrative symbol **UP** from the VOS Database if an ATF annual update filing for the common stock appears in ISIS and the SVO has received the necessary information required to assign an NAIC Designation to the common stock. If a common stock is not deleted in accordance with the foregoing process in reliance on an annual update ATF that does not contain the necessary information to permit the assignment of a valuation, the SVO shall subsequently delete that security from the database.

Part Two – Filing With the SVO

Section 1. **General Definitions Used in This Manual**

The following definitions are intended to have relevance only for this Manual. No suggestion is intended that these definitions have any relevance to any other NAIC publication.

**Authorization to File (ATF)** means the component of ISIS that permits reporting insurance companies to file a security with the SVO.
Automated Valuation Service (AVS) means a subscription service offered by the NAIC permitting access to portions of the VOS Database and showing updated Association Values prior to publication in the VOS Products.

Initial Report means the report and documentation filed with the SVO by a reporting insurance company as discussed in Section 10(a) of this Part below.

InfoReq means an information request sent by the SVO to a reporting insurance company detailing informational deficiencies associated with an Initial or a Subsequent Report, as discussed in Section 11 of this Part below.

Inquiry Service means the reporting insurance company's view of the Work Flow component of ISIS.

ISIS stands for Integrated Securities Information System and refers to the SVO's electronic computer system for reporting and tracking securities.

SIC Code stands for Standard Industrial Code and refers to a 4-digit classification scheme established by the U.S. Department of Commerce for organizing commercial entities by industry specialization.

Subsequent Report means the report and documentation filed with the SVO by a reporting insurance company as discussed in Section 11 of this Part below.

SVO stands for the Securities Valuation Office of the NAIC and refers to the portion of the Executive Headquarters that serves as the professional staff of the Valuation of Securities (E) Task Force (VOS/TF).

Unit Price means the value determined for a security by the SVO pursuant to Part Five, Section 1 of this Manual for purposes of valuation under SAP.

VOS Database means the Valuation of Securities Database and refers to that component of the SVO's Integrated Securities Information System (ISIS) used to store the names and descriptions of securities owned by state-regulated insurance companies, together with the NAIC Designation categories and/or Unit Price assigned to them.

VOS Products refers to the quarterly compilation of information derived from the VOS Database, the FE Datafile, Unit Prices assigned by the SVO and Unconfirmed FE’s.

Work Flow means the component of the SVO's Integrated Securities Information System (ISIS) that tracks submission and status of all Initial and Subsequent Reports filed by, or on behalf of, reporting insurance companies.

Section 2. General Reporting Framework

d) Reporting Responsibilities

Reporting is the responsibility of the insurance company that has purchased the investment. There are procedures that reduce multiple reporting on the same securities by different insurance companies. These procedures are discussed below.

As a general rule, the reporting of privately placed securities is the responsibility of the insurance company lender with the largest dollar investment in the transaction. Also, only previously unreported investments need be reported to the SVO. To ascertain whether another insurance company has previously reported a security to the SVO, the reporting insurance company should consult the most recent VOS Products, the Automated Valuation Service or Inquiry Service.

No reporting is necessary if the security (i) is listed in the VOS Products with a recently assigned NAIC Designation/Unit Price, (ii) is listed in the Automated Valuation Service with a current year
review date and a symbol that is other than an NR or UP or (iii) has been logged into Inquiry Service.

f) Security Identification Numbers

No security may be reported to the SVO without a valid CUSIP, PPN or CINS Identifier. Only S&P CUSIP may assign CUSIP Identifiers, PPNs and CINS.

To obtain filing and fee information and a CUSIP Identifier, PPN or CINS number, reporting insurance companies must contact S&P CUSIP at: CUSIP Service Bureau, Standard & Poor's Corporation, Attention: Senior Copy Editor, 55 Water Street, 47th Floor, New York, N.Y. 10041, e-mail address is cusip_ppn@standardandpoors.com, Facsimile (212) 438-6572.

Section 5. Special Reporting Instruction

a) NAIC Designations Related to the Special Reporting Instruction

NAIC 5* is assigned by the SVO to certain obligations when an insurer certifies: (1) that documentation necessary to permit a full credit analysis of a security does not exist and (2) the issuer or obligor is current on all contracted interest and principal payments and (3) the insurer has an actual expectation of ultimate payment of all contracted interest and principal. This use of an NAIC 5* Designation is connected with the Special Reporting Instruction contained in Section 5(b) of this Part below. The NAIC 5* Designation is also assigned to certain securities pursuant to policy decisions adopted by the Valuation of Securities Task Force. Securities with NAIC 5* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 5 Designation. Therefore a security assigned an NAIC 5* Designation should incur the same regulatory treatment associated with an NAIC 5 Designation. The asterisk (*) after the quality indicator 5 distinguishes the NAIC 5* Designation from the NAIC 5 Designation that is only assigned by the SVO after a full credit analysis.

NAIC 6* is assigned by an insurer to an obligation in lieu of reporting the obligation with appropriate documentation to the SVO for a full credit analysis or filing the certification required for obtaining an NAIC 5* Designation. This use of an NAIC 6* Designation is connected with the Special Reporting Instruction contained in Section 5(b) of this Part below. An NAIC 6* Designation is also assigned by the SVO to an obligation that was assigned an NAIC 5* Designation in a given year if no Subsequent Report is received by the SVO. Securities with NAIC 6* Designations are deemed to possess the credit characteristics of securities assigned an NAIC 6 Designation. Therefore a security assigned an NAIC 6* Designation should incur the same regulatory treatment associated with an NAIC 6 Designation. The asterisk (*) after the quality indicator 6 distinguishes the NAIC 6* Designation from an NAIC 6 Designation that is only assigned by the SVO after a full credit analysis.

b) Special Reporting Instruction – Use of the Administrative Symbol Z Schedule D

An insurance company may report a security with a “Z” suffix on its Schedule D for up to a year after purchase. For the second year after purchase, and thereafter, the insurance company may not report a security with a “Z” suffix except as noted in Section 5(d) of this Part below.

The insurer shall either file the security and appropriate documentation with the SVO to obtain an NAIC Designation, file a Principal and Interest Certification Form to obtain an NAIC 5* Designation or report the security with an NAIC 6* Designation on its Schedule D (collectively, the “5*/6* Rule”).
An insurance company that decides to file a Principal and Interest Certification Form for a security, pursuant to the 5*/6* Rule, should do so by October 1.

c) Application of the 5*/6* Rule

Insurers are required to apply the 5*/6* Rule to all Annual Statements beginning with the 1999 Annual Statement. The 5*/6* Rule applies only to securities owned in the prior year. For example, in the 1999 Annual Statement filing, the 5*/6* Rule would have applied to securities that had been listed with a “Z” as of December 31, 1998.

d) Exemption from Application of the 5*/6* Rule

The 5*/6* Rule will not be held to apply to a security that has been:

(i) Filed in a timely manner after purchase of such security (that is, within 120 days), and
(ii) For which a complete filing (including any annual filing that would have been required if the original filing had received an NAIC Designation) is received by the SVO by September 1, if the SVO has not reviewed such security by year-end.

For these securities, a “Z” suffix is reported on Schedule D.

e) Documentation

Insurance companies are instructed to maintain a record of the purchase and filing dates of the securities they file with the SVO.

f) Use of NAIC 5* Designation

An insurer may file a Principal and Interest Certification Form with the SVO when it can certify:

(i) That documentation necessary to permit a full credit analysis of a security does not exist;
(ii) The issuer or obligor is current on all required interest and principal payments; and
(iii) The insurer has an actual expectation of ultimate payment of all required interest and principal.

The SVO may assign the NAIC 5* Designation to corporate, municipal and to structured securities that have never been rated by an NAIC CRP.

An NAIC 5* Designation can only be assigned by the SVO. The SVO shall assign an NAIC 5* Designation upon a review of a fully completed and executed Principal and Interest Certification Form.

The submission of the Principal and Interest Certification Form does not preclude the SVO from conducting an analytical review of the security. Upon such review, in cases where assigning an NAIC 5* Designation appears inconsistent, the SVO shall apply appropriate analytical procedures to assure an accurate designation.

The SVO is not responsible for assessing the truth or accuracy of the Principal and Interest Certification Forms that are filed by insurers or for monitoring any other aspect of this Special Reporting Instruction.

g) Use of NAIC 6*Designation
An insurer may assign an **NAIC 6** Designation to corporate and municipal securities and to structured securities that have never been rated by an NAIC CRP.

The insurer shall assign an **NAIC 6** Designation to a security when:

(i) The documentation necessary to permit a full credit analysis of a security does not exist;
(ii) The insurer cannot certify that the issuer or obligor is current on all required interest and principal payments; and
(iii) The insurer cannot certify that it expects ultimate payment of all interest and principal.

The SVO may assign a security an **NAIC 6** Designation when the security was assigned an **NAIC 5** Designation in a previous year but no Subsequent Report has been received by the SVO.

**h) Unit Price of NAIC 6** Securities

An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an **NAIC 6** Designation and a Unit Price not greater than zero is not obligated to file a Principal and Interest Certification Form for the security with the SVO. An insurer that intends to report a security on its annual or quarterly financial statement (NAIC Financial Statement Blank) with an **NAIC 6** Designation and a Unit Price greater than zero shall file a Principal and Interest Certification Form for the security with the SVO.

**i) Other Permitted Uses of the Principal and Interest Certification Form and the NAIC 5 and 6 Designations**

(i) **Corporate Bonds and Preferred Stock with Unaudited Financial Statements**

The Principal and Interest Certification Form and the **NAIC 5** Designation may be used in connection with the designation of corporate securities with unaudited financial statements as specified in Part Three, Section 1(a)(ii)(B) of this Manual.

(ii) **Residential Mortgage Backed Security (RMBS)**

The Principal and Interest Certification Form and the **NAIC 5** and **6** Designations may be used in connection with an RMBS that has never been rated by an NAIC CRP as specified in Part Seven, Section 5(a)(iv)(B) of this Manual.

(iii) **Commercial Mortgage Backed Securities (CMBS)**

The Principal and Interest Certification Form and the **NAIC 5** and **6** Designations may be used in connection with a CMBS that has never been rated by an NAIC CRP as specified in Part Seven, Section 5(a)(iv)(B) of this Manual.

(iv) **Foreign Securities of Issuers Domiciled with No NAIC CRP Sovereign Rating**

The Principal and Interest Certification Form and the **NAIC 5** and **6** Designations may be used in connection with reporting foreign securities issued in countries that have not been assigned a sovereign rating by an NAIC CRP as specified in Part Three, Section 1(a)(ii)(D)(2) of this Manual.

(v) **Parent-Subsidiary Situations**

The Principal and Interest Certification Form and the **NAIC 5** and **6** Designations may be used in connection with reporting parent-subsidiary situations as specified in Part Three, Section 1(a)(ii)(E) of this Manual.
(vi) Military Housing Bonds or Securities Issued On or After Dec. 31, 2009 and Not Rated by an NAIC CRP
The Principal and Interest Certification Form and the NAIC 5* Designation may be used in connection with the designation of military housing bonds or securities that were issued on or after Dec. 31, 2009, and were not rated by an NAIC CRP pursuant to the policy determination expressed in Part Four, Section 5(c) of this Manual.

(vii) Other Catastrophe-Linked Bonds
The Principal and Interest Certification Form may be used to report a Catastrophe-Linked Bond that has not been assigned a credit rating by an NAIC CRP and those that have been assigned a credit rating by an NAIC CRP on the basis of a methodology other than that specified in Part Four, Section 4(a)(iii) of this Manual.

Catastrophe-Linked Bonds not assigned a credit rating by an NAIC CRP and those assigned a credit rating by an NAIC CRP on the basis of a methodology other than that specified in Part Four, Section 4(a)(iii) of this Manual shall be reported to the SVO and assigned an NAIC 6* Designation by the SVO.

Section 6. The Mechanics of Reporting With the SVO

Determining whether a security subject to reporting under Section 2(a) of this Part above has been reported to the SVO is accomplished through a computer link up with SVO's Integrated Securities Information System (ISIS). If the security has not been previously reported to the SVO and is not known to be exempt, ISIS will assign an Authorization To File (ATF) number at the end of the ATF process. The reporting entity receiving an ATF number must then file the completed ATF form and required documentation with the SVO office. The following is a summary description of the steps in the reporting confirmation process.

(a) Link to ISIS
(b) Login by presenting appropriate username and password
(c) Go to the Authorization to File (ATF) process
(d) Enter the valid CUSIP/PPN/CINS identifier of the security to be reported. ISIS will then process that security based on its identifier:

(i) Already Contained in VOS Database:
If the CUSIP identifier is found in the VOS database with a current year review date, ISIS will deny the reporting entity's request to file an initial or subsequent report and display a message that the CUSIP/PPN/CINS already exists in VOS. If so, this ends the reporting process for that security.

(ii) Previously Reported/ATF Already Issued:
(A) If the CUSIP/PPN/CINS identifier does not exist in the VOS database but is found in Inquiry Service due to reporting by another reporting entity, ISIS will deny the entity's request to file an initial or subsequent report and will display a message that an ATF number has been issued or an ATF filing has been received.
(B) If an ATF number has been issued, Inquiry will display the CUSIP/PPN/CINS identifier, ATF number, and the date of ATF expiration or the date the SVO received the ATF submission.
(C) If the ATF submission is not received at the SVO by the ATF expiration date, ISIS will delete the CUSIP/PPN/CINS identifier from Inquiry. If this occurs, it is the responsibility of the reporting entity to re-report the security.
(D) If an ATF submission has been received at the SVO, this ends the reporting process for that security.

(iii) Already Deemed to be Filing Exempt:
(A) If the CUSIP/PPN/CINS identifier is found in the Filing Exempt data file, ISIS will display a message that informs the entity that the security is Filing Exempt.
(B) The entity is then given the option to continue the ATF process in spite of the security’s FE status (for instance, if required by a state regulator). If the answer is “No” that ends the reporting process for that security.

(iv) Not Yet Deemed to be Filing Exempt:
(A) If the CUSIP/PPN/CINS identifier is not found in the Filing Exempt data file, the reporting entity may request through ISIS that the security be run through the filing exempt application. This can be done even if the security is found in the VOS database or Inquiry Service.
(B) ISIS will search the NAIC CRP feeds for a match and, if a match is found, the application will translate the NAIC CRP ratings into the equivalent NAIC designation, which will be available in the subsequent FE data file. The reporting entity will have to access the FE data file contained within AVS on the following day in order to view the equivalent NAIC designation.
(C) The entity is then given the option to continue the ATF process in spite of the security’s FE status (for instance, if required by a state regulator). If the answer is “No,” that ends the reporting process for that security.

(v) Filing Required:
(A) If the CUSIP/PPN/CINS identifier entered by the reporting entity is not Filing Exempt, in VOS, or in Inquiry Service, ISIS will grant the filer access to a series of menu options designed to permit the entity to bring up the appropriate ATF filing form on its personal computers, fill out necessary information and generate a hard copy form of the ATF for filing with the SVO.
(B) ISIS will permit the reporting entity to access, electronically, all of the forms that are required to be filed with the SVO, (with the exception of the Application for Regulatory Treatment Analysis Service, which can only be submitted on an original hard copy form obtained from the SVO). The printed ATF and other applicable forms are then to be forwarded to the SVO with the required documentation for the security within 120 days of the triggering event. The reporting process for this security is complete when the ATF submission and filing has been received by the SVO.
(C) When the ISIS processing of a security is complete (an ATF is either issued or denied), ISIS will ask the entity if it wishes to enter the CUSIP/PPN/CINS identifier of a new security. If you have a question about filing requirements for a given security, consult the How To Comply Manual, which is available from the NAIC Publications Department. See the notice at the end of the table of contents.

Section 7. When to Use the Securities Acquisition Report (SAR)

A security issued by an entity unaffiliated with the reporting company is reported by creating, completing and submitting the SAR form. The reporting insurance company must submit the SAR to the SVO not later than 120 days after the purchase of the security.
a) SIC Code

As an internal administrative matter, for all Corporate securities, the SVO will distribute Initial and Subsequent Reports in accordance with the industry specialization of SVO's credit analysts. Therefore, the Industry Code identified on the SAR must be accurate. The reporting insurance company chooses the correct Industry Code from a menu embedded in ISIS. Only the first two digits of the Code itself are necessary for SVO purposes. For example, the SIC Code for a luggage manufacturing company is 3160 but, for SVO purposes, the SIC Code 3100 (Leather and Leather Products) is sufficient. The SVO Help Desk will provide assistance in determining the correct SIC Code.

Section 10. Reporting Conventions and Required Documents

a) Initial Report

An initial filing consists of a completed form(s) and information, documentation and data in quantity and quality sufficient to permit the SVO to conduct an analysis of the creditworthiness of the issuer and the terms of the security to determine an Association Value. It is the obligation of the reporting insurance company to provide the SVO with all necessary information. It is the responsibility of the SVO to determine whether the information provided is sufficient and reliable for its purposes and to communicate informational deficiencies to the reporting insurance company.

b) Informational Deficiencies

Upon receipt of a submission by a reporting insurance company, the submission is logged into Work Flow by date and time received and assigned to the appropriate staff analyst for credit assessment or unit pricing. If the staff analyst determines that there is an informational deficiency, he or she will complete an InfoReq letter, log the InfoReq into Work Flow and provide a copy to the reporting insurance company.

The transaction for which the InfoReq was issued will be held without processing for a period not to exceed 45 days. If, at the completion of the 45 days, the reporting insurance company has failed to provide the information requested, the SVO will discard the filing and all documentation submitted with it and Work Flow will reflect that the filing was discarded due to insufficient information.

On an exception basis, the SVO may grant an InfoReq response extension to the reporting insurance company but not to exceed 90-days in total with the time-period to begin on the date that the InfoReq was issued. If such an extension is granted, and if the reporting insurance company has failed to provide the information requested within the time provided, the SVO will discard the filing and all documentation submitted with it at the end of the 90-day period and Work Flow will reflect that the filing was discarded due to insufficient information.

Either at the expiration of the 45-day or 90-day period InfoReq response period, the reporting insurance company shall be obligated to file the security again if it wishes to obtain an NAIC Designation.

If the SVO determines it requires additional information after an InfoReq response has been received, a new 45-day period shall begin, unless an InfoReq response extension is granted as indicated above, in which case a new 90-day period will begin.

Section 11. Subsequent Reporting
a) Annual Filing Requirement

(i) Filing Exempt Securities
No subsequent report is required for the purposes of valuation of securities under Part Five, Section 1 of this Manual and no subsequent report is required for filing exempt securities unless they no longer qualify as filing exempt. Instructions for filing exempt securities are detailed in Section 4(d) of this Part.

(ii) All Other Securities
Any insurance company that owns a security listed in the VOS Database, which is not filing exempt as set forth in Section 4(d) of this Part above can satisfy subsequent reporting requirements by filing the additional or annual information described below. For purposes of this Manual, it is assumed that reporting responsibility is borne by the company that has filed the Initial Report. However, the SVO recognizes the possibility that the initial reporting insurance company may have sold its investment. Therefore, any insurance companies with an interest in a security may need to submit the information necessary to enable the SVO to complete its annual review. Annual filings should be reported to the SVO on the Annual ATF.

b) Material Credit Events Filing

It is the responsibility of the reporting insurance company to file all information that indicates a change in the credit characteristics of the issuer or a material change in the terms of the agreement.

What constitutes a material change will vary in accordance with the nature of the transaction. For purposes of this subsection, a material credit event is any occurrence that affects or is substantially likely to affect the issuer's ability to pay the obligation in accordance with its terms.

A determination that a bond is impaired for purposes of SSAP No. 26 is a material credit event under this subsection. Accordingly, when an insurer determines that a bond is impaired under SSAP No. 26, it shall file relevant information with the SVO under this subsection.

Material events should be reported to the SVO on the Material Change/Additional Information ATF. The SVO assumes that the information filed will be accurate and will reflect all information relevant to the material event in the possession of the reporting insurance company. The SVO will not audit the information submitted by the insurance company.
May 14, 2015

Mr. Stewart Guerin, Chair
NAIC Valuation of Securities (E) Task Force
National Association of Insurance Commissioners
1100 Walnut Street
Suite 1500
Kansas City, MO 64106-2197

Re: Discussion – Improvements to NAIC Systems and Rules Governing Insurer Filing of Securities with the SVO

Dear Mr. Guerin:

The American Council of Life Insurers (ACLI)\(^1\) appreciates the opportunity to provide comments on the discussion of the Improvements to NAIC Systems and Rules Governing Insurer Filing of Securities with the SVO.

We believe the intent of the SVO’s memorandum was to inform members of the task force of the need to update its computer systems and processes related to filing of securities submitted to the SVO. Industry understands this need and encourages improvements be made to the filing systems and processes to improve the quality and efficiency of the SVO’s assessments. During the VOS Task Force meeting held during the 2015 NAIC Spring Meeting, NAIC staff proposed that the Task Force direct industry to identify the professional staff concerned with the filing and investment processes and direct the SVO to meet with this group under the Task Force’s supervision to develop proposed alternative filing frameworks that can then be presented to the Task Force and other NAIC regulator groups for consideration. Industry supports this proposal and welcomes the opportunity to work with the SVO on these issues.

In the memorandum presented to the task force the SVO explains their preliminary observations with suggested improvements. The following are industry comments addressing these suggestions.

**Integrating all filing rules and processes into one Part of the Purposes and Procedures Manual**

Industry agrees that this would be beneficial and supports this change.

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\(^1\) The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with 284 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers’ products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at [www.acli.com](http://www.acli.com).
Requiring initial filings of newly acquired securities to be filed not more than 30 days after purchase
While some newly acquired securities can be filed with the SVO within 30 days of purchase, this does not hold true for most investments. All legal documents and financial statements required by the SVO to constitute a complete filing are not always available within the proposed 30-day timeframe. It is not uncommon for a deal to close with the formal finalized documents to be delivered at a later date. In many instances, the investors must wait for outside counsel to provide the formal legal documents required by the SVO. Another issue with a 30-day filing timeframe would involve securities purchased in January and February of any given year. The SVO requires the filer submit the prior year’s audited financials which may not be available until April or May at the earliest.

It should also be noted that in some cases companies may need to file for a Private Placement Number (PPN) with CUSIP Global Services before filing the security, which will add to the timing that the security can be filed.

The SVO should be designating an insurer as the “Filer of Record”
In the memo from the SVO it is stated that the initial filer of a security is assumed to be the one responsible for the security and designated as the “Lead Lender” and thus would be responsible for the annual update going forward. The SVO would like to store this information as “Filer of Record”. The Lead Lender or Filer of Record must then absorb all of the filing fees for the subsequent annual updates as the system is set up today. This is prejudicial against larger investors that tend to take the lead in the private placement market more often. These companies would be submitting a majority of the filings with the SVO and taking on the burden of needing additional staff and an increasing filing budget. As filing fees continue to increase, these issues will persist – not to mention that through the life of a security, there may be sales or transfers, and the “Lead Lender”/“Filer of Record” could change.

We would suggest that, in lieu of the individual filing fees, there be an alternative method of payment by either allocating the filing costs to all holders in the deal or establishing an assessment fee of Insurer’s holdings to be collected to cover filing costs. This would encourage any holder of a particular security to submit the filing without having to incur the total filing fee. Filings would no longer be attributed to a fee and the assessment would be collected from all holders of securities to defray these costs similar to the AVS fees and the Modeling fees that are already in place within the NAIC.

ATF filing to be formally “Accepted” through an acknowledgement by the SVO
While industry understands the benefits to this suggestion, we are concerned that a company would be required to report a newly acquired security as out of compliance – if the initial filing is not formally accepted by the SVO in a timely manner.

Insurer filing of Material Credit Events
The memorandum states that insurers rarely submit Material Credit Event Filings and that appropriate SSAPs be modified to require that the insurer demonstrate that the security was filed with the SVO for evaluation as part of the statutory reporting process pertaining to impairment and related accounting processes. While we feel insurers are monitoring securities for impairment and applying a write down along with assigning a 6* designation, we are not certain that they are notifying the SVO of the credit event. We would appreciate the opportunity to investigate and discuss this matter further.

Expanding the use of the NR (Not Rated) and UP (Unable to Price) administrative symbols and enforcing a required timeframe for submitting annual update filings
While we do acknowledge that efforts can be made by industry to make sure annual update filings are submitted in a timelier manner, we feel establishing a required filing timeframe would put undue burden on insurance companies by requiring them to add staff in order to meet these deadlines. It should be noted that it is typical for a company’s filer to have additional assigned tasks. These tasks, especially during year-end and quarter-end reporting periods, would take priority over their filing duties.
The “Z” administrative symbol process
The “Z” designation suffix was created to indicate that the reported designation was derived from the insurance company and not the SVO. Industry uses this as a temporary placeholder for new purchases that have not been assigned a designation by the SVO or an NAIC CRP. We do agree that it would be beneficial to have an administrative symbol assigned to securities at year-end indicating that the filing has been received by the SVO and is considered compliant with the filing policies, but it should not be the “Z” administrative symbol.

Relevancy of the 5*/6* process
Currently, the 5*/6* process is the only option industry has in assigning an NAIC designation to unrated securities for which the SVO is unable to complete a full credit analysis. When filing for a 5* designation, the insurance company signs and submits a Principal and Interest Certification Form attesting that all documentation required by the SVO is not available, that the issuer is current on principal and interest payments, and is ultimately expected to make all required interest and principal payments. When filing for a 6* designation, the company is attesting that all required documentation is not available and that they cannot certify that the principal and interest payments are current, nor that ultimate payment of principal and interest will be made. This process is relevant in that it is needed by industry to report an unrated security as an admitted asset and to determine its RBC treatment.

Industry currently uses the 5*/6* process for:
- Foreign holdings in which the countries’ audited financials are not accepted by the SVO
- Securities where all documents requested by the SVO cannot be delivered
- Investments with start-up companies which cannot meet the SVO requirement of 3 years historical financials
- Securities that the SVO does not have the expertise to analyze and designate (Ex. - catastrophe bonds)
- Structured Securities that are not financially modeled and do not have a current NAIC CRP rating

Also, insurance companies have the option to self-rate NAIC 6* securities in the following scenarios:
- if a security does not have sufficient information or proper documentation to obtain a Private Placement number
- where a company believes that the holding’s book value is not material and would rather take the penalty of the highest RBC charge, rather than filing with the SVO for a higher rating and spend the money (cost versus benefit).

We thank you for allowing us to comment on this memorandum and welcome the opportunity to assist in developing a proposal to refine and update the filing processes to be presented to the task force.

Sincerely,

Mike Monahan
Senior Director, Accounting Policy