The Reinsurance (E) Task Force met via conference call Feb. 24, 2015. The Valuation of Securities (E) Task Force also participated (see Valuation of Securities (E) Task Force, Feb. 24, 2015, minutes). The following Reinsurance (E) Task Force members participated: John M. Huff, Chair (MO); Dave Jones, Vice Chair, represented by John Finston and Kim Hudson (CA); Allen W. Kerr represented by Mel Heaps (AR); Anne Melissa Dowling represented by Kathy Belfi (CT); Karen Weldin Stewart represented by Rylynn Brown (DE); Kevin M. McCarty represented by Kerry Krantz (FL); Ralph T. Hudgens represented by Trey Sivley (GA); TBD represented by Eric Moser (IL); Stephen W. Robertson represented by Cindy Donovan (IN); Ken Selzer represented by Tian Xiao (KS); James J. Donelon represented by Stewart Guerin and Tom Travis (LA); Eric A. Cioppa represented by Robert Wake (ME); Gary Anderson represented by Robert Macullar (MA); Bruce R. Ramge represented by Bruce Bornman, Lindsay Crawford and Justin Schrader (NE); Kenneth E. Kobylowski represented by Richard Schlesinger (NJ); Benjamin M. Lawsky represented by Martha Lees (NY); John D. Doak represented by Joel Sander (OK); Teresa D. Miller represented by Steve Johnson (PA); Angela Weyne represented by Ruben N. Gely Rodriguez (PR); Todd E. Kiser represented by Brett J. Barratt (UT); Jacqueline K. Cunningham represented by Doug Stolte (VA); Mike Kreidler represented by Patrick McNaughton and Tim Hays (WA); and Ted Nickel represented by Randy Milquet (WI).

1. **Approved Membership of its 2015 Working and Drafting Groups**

Director Huff advised the members of the Task Force that it is necessary to reconstitute the membership of the working and drafting groups of the Task Force for 2015. NAIC staff prepared a memorandum identifying members of the Reinsurance Financial Analysis (E) Working Group and the Qualified Jurisdiction (E) Working Group, as well as the XXX/AXXX Captive Reinsurance Regulation Drafting Group, which is not a formal NAIC working group and meets in regulator-to-regulator session (Attachment A). Mr. Finston made a motion, seconded by Ms. Donovan, to reconstitute membership of the working groups and drafting group of the Task Force in accordance with the NAIC staff memorandum (Attachment A). The motion passed unanimously.

2. **Heard an SVO Research Report: Should the NAIC Bank List be Expanded to a Qualified U.S. Financial Institutions List**

Director Huff advised the Task Force that this was a joint conference call with the Valuation of Securities (E) Task Force and that members of the Reinsurance (E) Task Force were invited to listen to the Valuation of Securities (E) Task Force meeting. Robert Carcano (NAIC) led a discussion with respect to a memorandum dated Dec. 22, 2104: “Research on the Regulation of Banks and Non-Banks in Connection with the Possible Conversion of the NAIC (Letter of Credit) Bank List into a List of Qualified U.S. Financial Institutions (as Defined in the Credit for Reinsurance Model Act [Model #785]).” The Valuation of Securities (E) Task Force adopted a motion to refer this matter to the Reinsurance (E) Task Force for further review and action.

3. **Heard an SVO Report: SVO Compilation Function and the Meaning of SVO Listed Securities in the Credit for Reinsurance Model Law**

Mr. Carcano then led a discussion on a memorandum dated Dec. 4, 2014: “Joint Project — Meaning and Intent of the Phrase ‘Securities Listed by the SVO’ in Section 3 B. of the NAIC Credit for Reinsurance Model Law (#785) (Model Law) and Section 10 A. (2) of the Credit for Reinsurance Model Regulation (#786) (Model Regulation) — Proposed Amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (Purposes and Procedures Manual).” The Valuation of Securities (E) Task Force adopted a motion to expose this report for a 30-day public comment period and refer the matter to the Reinsurance (E) Task Force for further review and action.

Having no further business, the Reinsurance (E) Task Force adjourned.

© 2015 National Association of Insurance Commissioners
This page intentionally left blank.
The Reinsurance (E) Task Force met via conference call Dec. 11, 2014. The following Task Force members participated: John M. Huff, Chair (MO); Dave Jones, Vice Chair, represented by John Finston and Kim Hudson (CA); Jay Bradford represented by Mel Anderson (AR); Thomas B. Leonard represented by Kathy Belfi (CT); Karen Weldon Stewart represented by Linda Sizemore (DE); Kevin M. McCarty represented by David Altmairer (FL); Ralph T. Hudgens represented by Trey Sivley (GA); Andrew Boron represented by Eric Moser (IL); Stephen W. Robertson represented by Cynthia D. Donovan (IN); James J. Donelon represented by Tom Travis (LA); Gary Anderson represented by John Turchi (MA); Eric A. Cioppa represented by Robert Wake (ME); Bruce R. Ramge represented by Lindsay Crawford (NE); Kenneth E. Kobylowski represented by Richard Schlesinger (NJ); Benjamin M. Lawsky represented by Martha Lees (NY); John D. Doak represented by Joel Sander (OK); Michael F. Considine represented by Steve Johnson and Kimberly Rankin (PA); Joseph Torti III (RI); Todd E. Kiser represented by Brett J. Barratt (UT); Jacqueline K. Cunningham represented by Doug Stolte (VA); Mike Kreidler represented by Tim Hays, Jim Odiorne and Bill Michels (WA); and Ted Nickel represented by Randy Milquet (WI).

1. **Adopted its Nov. 17 Minutes**

Director Huff said that the first item was for the Task Force to consider adoption of its Nov. 17 minutes from the Fall National Meeting. Mr. Finston made a motion, seconded by Mr. Schlesinger, to adopt the minutes. The motion passed unanimously.

2. **Adopted Summary of Findings and Determination(s) of Qualified Jurisdictions**

Director Huff asked Mr. Finston, as chair of the Qualified Jurisdiction (E) Working Group, to lead the discussion on the Summary of Findings and Determinations (Attachment A) recommending approval of each of the following seven jurisdictions as “qualified jurisdictions” under the Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions (Qualified Jurisdiction Process): 1) Bermuda Monetary Authority (BMA); 2) Central Bank of Ireland (Central Bank); 3) Financial Services Agency of Japan (FSA); 4) France: Autorité de Contrôle Prudentiel et de Résolution (ACPR); 5) Germany: Federal Financial Supervisory Authority (BaFin); 6) Switzerland—Financial Market Supervisory Authority (FINMA); and 7) United Kingdom: Prudential Regulation Authority of the Bank of England (PRA). These Summaries of Findings and Determinations were released by the Qualified Jurisdiction (E) Working Group for public comment on Nov. 12 and Nov. 21.

Mr. Finston briefly summarized the process by which the Working Group evaluated each jurisdiction. The NAIC initially approved four jurisdictions—Bermuda, Germany, Switzerland and the United Kingdom—as conditional qualified jurisdictions effective for a one-year period beginning Jan. 1, 2014, subject to a full review during 2014. The Working Group also issued invitations to three additional jurisdictions—France, Ireland and Japan—to be evaluated under the Qualified Jurisdiction Process in 2014. The Working Group notified both the Federal Insurance Office (FIO) and the United States Trade Representative (USTR) of these reviews, and the Working Group posted notice for a 30-day comment period. The Working Group received one comment letter with respect to each jurisdiction, all of which were in favor of their approval as qualified jurisdictions.

Mr. Finston stated that the Working Group then performed an initial evaluation of each jurisdiction’s regulatory system by using the information identified in Sections A through G of the Evaluation Methodology of the Qualified Jurisdiction Process. This included a review of each jurisdiction’s most recent Financial Sector Assessment Program (FSAP)/Reports on Standards and Codes (ROSC) report; the European Insurance and Occupational Pensions Authority (EIOPA) Solvency II Equivalency Assessment, where applicable; and other publicly available information regarding the reinsurance laws, regulations, practices and procedures applicable for each jurisdiction. The Working Group also invited each jurisdiction to provide information to update the publicly available information.

Mr. Finston said that NAIC staff then collected all the information for each jurisdiction and created confidential workpapers containing the staff’s initial review and findings with respect to each jurisdiction, which was reviewed by the Working Group in a series of seven regulator-to-regulator conference calls held between September and November, and a regulator-to-regulator meeting on Nov. 17. Following these meetings, the Working Group submitted additional questions to each
jurisdiction on issues that were raised during the reviews. Upon reviewing the responses to these questions, the Working Group issued a Preliminary Evaluation Report to each jurisdiction containing the Working Group’s initial findings and preliminary recommendation. After giving each jurisdiction an opportunity to respond to this report, the Working Group issued its Final Evaluation Report, and subsequently issued a Summary of Findings and Determination for a two-week public comment period. The Working Group received one comment letter, which recommended approval of each of the seven as qualified jurisdictions.

Mr. Finston continued that the standard for approval under the Qualified Jurisdiction Process is that the NAIC must reasonably conclude that: 1) the jurisdiction’s reinsurance supervisory system achieves a level of effectiveness in financial solvency regulation that is deemed acceptable for purposes of reinsurance collateral reduction; 2) the jurisdiction's demonstrated practices and procedures with respect to reinsurance supervision are consistent with its reinsurance supervisory system; and 3) the jurisdiction’s laws and practices satisfy the criteria required of qualified jurisdictions as set forth in the NAIC Credit for Reinsurance Models. Mr. Finston also noted that each Summary of Findings and Determination lists the procedural history of the evaluation, along with the evaluation materials that were reviewed. Finally, each report provides a recommendation with respect to each jurisdiction reviewed, along with any specific issues or limitations that were noted. For example, the Working Group recommended that Bermuda’s approval be limited to reinsurers of Class 3A, Class 3B and Class 4, and long-term insurers of Class C, Class D and Class E.

Director Huff stated that the NAIC had kept both the FIO and the USTR updated on all the activities that had taken place with respect to the work of the Qualified Jurisdiction (E) Working Group. Director Huff noted that under the Qualified Jurisdiction Process, this matter does not go to the Financial Condition (E) Committee but will go straight to the Executive (EX) Committee and Plenary for a vote, which is scheduled to take place on an open conference call Dec. 16.

Director Huff then asked for comments from regulators and interested parties. Dr. Marcelo Ramella (BMA) stated that Mr. Finston, as Chair of the Qualified Jurisdiction (E) Working Group, and Director Huff, as Chair of the Reinsurance (E) Task Force, provided good support and availability during the process. He noted that he sees this as the end of the process, but rather the beginning of a bigger process ahead, which he hopes will be mutually beneficial. Ms. Nathalie Quintart (ACPR) thanked the Task Force for all the work done and spoke in support of the process. Dr. Michael Popp (BaFin) stated that the process went smoothly, there was good cooperation, and good contacts were developed.

Mr. Finston made a motion, seconded by Ms. Belfi, to adopt the Summary of Findings and Determinations to approve each of the seven jurisdictions to be placed on the NAIC List of Qualified Jurisdictions. Mr. Finston noted that this approval would be valid for five years, absent a material change in circumstances, after which each jurisdiction would be subject to re-evaluation under the provisions of the Qualified Jurisdiction Process. The motion passed unanimously.

3. **Adopted Uniform Application Checklist for Certified Reinsurers**

Director Huff noted that the Task Force had discussed adoption of the Nov. 6 draft of the Uniform Application Checklist for Certified Reinsurers (Checklist) at the Nov. 17 meeting, but deferred action on this matter and sent the Checklist back to the Reinsurance Financial Analysis (E) Working Group for further review. Mr. Johnson stated that the Working Group met to discuss comments from regulators and interested parties in a regulator-to-regulator session Dec. 3. As a result of this meeting, the Working Group approved a new draft of the Checklist based on these comments (Attachment B), and directed Mr. Johnson to prepare a memorandum outlining the proposed revisions and describing the passporting process (Attachment C).

Mr. Johnson noted that the biggest remaining issue regarding the Checklist is the concept that state regulators are required to review the business practices of certified reinsurers; specifically, their claims adjudication practices. To try to make this process more efficient, the Working Group created a de minimus amount for disputed items that would not be required to be disclosed if it were below the designated threshold. If the amount of disputed claims were above this threshold, the Working Group would want this information, not to automatically disqualify a certified reinsurer for passporting, but to give the regulators the information to evaluate and have a dialogue with the applicant in order to determine whether there is an issue with prompt payment.

Mr. Johnson noted that the Task Force had received several comments stating that the wording used in the Nov. 6 draft of the Checklist would cause logistical issues for certain certified reinsurers for collecting this data. The Working Group consequently revised that section on disputed and overdue reinsurance claims to specifically address these comments, and permitted companies to be able to pool this information. Additionally, some commentators said that the 1% threshold was too low and that it should be 3%. However, Mr. Johnson stated that regulators wanted to start the bar at a lower amount because of the fact that certified reinsurers is a new concept and regulators want to gain comfort that there are no bad business
practices on claims adjudication with any of these certified reinsurers. The Checklist is not specifically prescribed in either law or regulation, and it can be changed again in the future as the Working Group acquires more history in dealing with certifying and passporting these applicants. Furthermore, the Working Group changed the language from “must” to “may” in order to address concerns that this was a bright line test that would automatically disqualify a certified reinsurer from passporting.

Mr. Johnson then stated that there was another question regarding Form CR-1, which includes certain representations that an applicant is required to make, and whether it must be filed only at the initial application or whether it must also be filed for each and every renewal period. The Working Group determined that these representations are the kind that should be made on a yearly basis, and that it is not overly burdensome to ask for the CR-1 to be filed each and every year with the renewal process.

Mr. Johnson stated that the Working Group is continuing to work on a uniform renewal date and the concept of a uniform renewal date process. Also, the Working Group has discussed whether there should be an aggregated list of companies that have been certified, as well as which states have passported them, and make it public information through the NAIC. Mr. Johnson concluded that the Task Force should move forward today with approving the Checklist, so that applicants and regulators can begin using it and to make the process more streamlined. The Working Group will continue to work on issues with respect to the Checklist, and may consider an open conference call with interested parties to further discuss these issues during the coming year.

Bill Marcoux (DLA Piper LLP) stated that the new language appears to respond to concerns raised by interested parties, and he observed that regulators may use the NAIC database to obtain a list of overdue reinsurance recoverables from Schedule F. Mr. Marcoux expressed concern that if an applicant meets the threshold for disputed or overdue reinsurance claims with respect to one of its top 15 individual U.S. cedents, the applicant would be obliged to: 1) provide a report on every claim for every one of the cedents that is in dispute; and 2) describe every claim with respect to each of those cedents that is more than 90 days past due. Joseph Gunset (Lloyd’s America) requested that the Working Group further review the 1% versus 3% threshold, which interested parties have recommended that the Task Force consider.

Mr. Johnson asked interested parties if they had experienced any issues with respect to passporting. Matthew Wulf (Reinsurance Association of America—RAA) stated that many companies were waiting for certain states to adopt the 2011 revisions to the Credit for Reinsurance Models, so they can get “more bang for their buck” with the application and passporting process. Sabrina Miesowitz (Lloyd’s America) commented that there may be some logistical issues with respect to passporting, but there are also some states that are not comfortable with the process yet. Director Huff stated that the passporting process was created for the reinsurance community and that the NAIC has put significant resources around it and wants to make sure it works. So if there are obstacles, the Task Force would like to have them identified and work through them. Mr. Johnson provided further clarification that if information has been filed with the Lead State, any state has access to that information, and a company applying for passporting should not be required to resubmit that information.

Mr. Finston stated that one of the issues that may have come up with respect to passporting is the fact that there was no uniform application. To the extent some states have asked for additional information, it may be a function of the fact that the Checklist has not yet been approved. Mr. Finston noted that by moving forward on it, there will be an opportunity to address many of the issues that have arisen.

Mr. Johnson made a motion, seconded by Ms. Belfi, to adopt the Dec. 3 draft of the Checklist. The motion passed unanimously.

4. Discussed Other Matters

Director Huff noted that the NAIC is expected to adopt Actuarial Guideline XLVIII (AG 48) on a conference call Dec. 16, and that it would then be appropriate for the XXX/AXXX Captive Reinsurance Model Regulation Drafting Group to begin its work on the model regulation. Under normal circumstances, an NAIC committee or task force cannot begin meetings in 2015 until the committee or task force has been re-constituted by NAIC leadership. However, since this is an informal drafting group and not an official NAIC group, Director Huff stated that it can begin its work immediately. Director Huff recommended to Mr. Stolte, chair of the Drafting Group, that he may begin work on this important project after the New Year.

Having no further business, the Reinsurance (E) Task Force adjourned.

© 2015 National Association of Insurance Commissioners
This page intentionally left blank.
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: Todd Sells, Director, NAIC Financial Regulatory Services
Charles Therriault, Director, NAIC Securities Valuation Office

DATE: December 22, 2014

RE: Research on the Regulation of Banks and Non-Banks in Connection with the Possible Conversion of the NAIC (Letter of Credit) Bank List into a List of Qualified U.S. Financial Institutions (as Defined in the Credit for Reinsurance Model Act [Model #785])

Executive Summary

Issue – The SVO was asked to assess whether qualified U.S. financial institutions, as defined in the NAIC Credit for Reinsurance Model Act (#785) and Model Regulation (#786) (collectively the Model Law), are at least as well regulated as banks. The request was made in connection with a proposal to expand the NAIC Bank List into a List of Qualified U.S. Financial Institutions.

Summary – From the perspective of federal and state banking regulation, the term “financial institutions” refers to banks (defined as entities that accept deposits and make loans) and non-banks (defined as entities that either accept deposits or make loans but do not do both).

- Federal Deposit Insurance Corporation (FDIC): regulates banks and savings associations (national banks, federal savings associations, federal branches, state banks [the term includes banks, banking associations, trust companies, savings banks, industrial banks or other banking institutions], state savings associations and insured state branches) and state banks that are not members of the Federal Reserve System (FRS).
- National Credit Union Administration (NCUA): regulates federally chartered and most state-chartered credit unions.
- FRS: regulates bank holding companies (BHCs), certain subsidiaries of BHCs, financial holding companies (FHCs), FHCs’ nonbank financial subsidiaries, securities holding companies (SHCs), savings and loan holding companies (SLHC), state banks that are members of the FRS, U.S. branches of foreign banks and foreign branches of U.S. banks.

Accordingly, the portion of the definition of qualified U.S. financial institution in the Model Law that requires that a financial institution be regulated by a state or federal banking regulator is consistent with how the federal-state regulatory banking framework operates. Banks organized as national banks are regulated by the OCC. State-chartered
banks are supervised jointly by their state bank regulator and either the FDIC or the FRS. Non-banks are supervised by the Board of Governors (Board) of the FRS, which also regulates state bank members and other banks. With the exception of SHCs, all of the financial institutions regulated by the identified federal bank regulators have authority to issue letters of credit (LOCs) directly or through specific subsidiaries. The research indicates that non-banks have had authority to issue LOCs for some time so that it is likely that some will have accumulated significant experience in LOC operations.

Recommendations

- Expanding the NAIC Bank List into an NAIC Qualified Financial Institutions List would not expose the reinsurance process to a lesser quality of regulation than obtained today for banks.
- The Model Law need not be amended because it already refers to an SVO list of U.S. financial institutions.
- If the Task Force moves to adopt the proposed expansion of the Bank List, more specific administrative instructions to the LOC issuer applicant are needed so the SVO can verify that an applicant meets the regulatory standard in the Model Law.

Analysis and Discussion

1. Introduction

a. Background – This memorandum communicates an SVO assessment whether qualified U.S. financial institutions, as defined in the NAIC Model Law, are at least as experienced and well regulated as banks. The issue arises from a proposal that the Task Force expand the NAIC Bank List into a List of Qualified U.S. Financial Institutions. The NAIC Bank List contains the names of banks that issue LOCs and meet specified financial criteria for issuing LOCs in support of a reinsurer’s obligation to a ceding insurer under the Model Law.

b. Summary – The Model Law permits an asset or a reduction from liability for reinsurance ceded by a ceding insurer to an assuming insurer in an amount held as security for payment of the reinsurance obligation. When the security is in the form of an LOC, the LOC must be issued or confirmed by a qualified U.S. financial institution. A qualified U.S. financial institution: 1) is organized or licensed under the laws of the U.S. or of any state; 2) is regulated, supervised and examined by U.S. federal or state authorities with regulatory authority over banks and trust companies; and 3) meets the financial condition standards acceptable to the commissioner or specified in the Purposes and Procedures Manual. In this assessment, we identify the various financial institutions that are: 1) authorized to issue LOCs by statute and or regulation; 2) organized and/or licensed under U.S. or state law; and 3) regulated, supervised and examined by U.S. federal or state banking regulators. We are assisted in this assessment because financial institutions are organized under special laws that strictly enumerate permissible banking or financial activities. If the activity is not enumerated, the financial institution cannot engage in the activity. U.S. financial institutions are regulated by one or more of four federal banking regulators: i.e., the OCC, the FDIC, the NCUA and the FRS. In addition, we examined the U.S. Securities and Exchange Commission (SEC) in relation to SHCs. With the exception of SHCs, all of the financial institutions that are regulated by the identified federal bank regulators are authorized to issue LOCs directly or through specific subsidiaries. All the financial institutions we identified also meet the requirement in the Model Law of being regulated, supervised and examined by U.S. federal or state banking regulators.

2. The Legal Framework Applicable to LOCs

a. What is an LOC – An LOC is an undertaking (i.e., obligation) obtained by an applicant for the benefit of a beneficiary by which an issuer agrees to pay a stipulated amount of money against the presentation of documents that comply with the terms and conditions of the credit. The issuer is obligated to pay solely on the documentary presentation and may not condition payment on the status of reimbursement obligations or any legal defense based on the underlying transaction.

b. Selecting the Governing Law – Parties to an LOC transaction will decide on the LOC framework that will apply to the transaction and to what extent the agreement should be customized. The parties to an LOC transaction will choose from a number of existing frameworks, of which perhaps the most well-known are the Uniform Custom and Practices for Documentary Credits (UCP) and Article 5 of the Uniform Commercial Code (UCC). Because these and other LOC legal regimes provide that the parties may, by agreement, vary how the provisions will apply to their transaction, it is also possible that the parties may pick and choose provisions from more than one legal regime to govern the transaction.
c. **Bank or Non-Bank Issuer** – Another core issue is the selection of the issuer and whether the issuer must be a bank or may be some other type of financial institution. While the UCP only refers to banks as issuers, the Commission on Banking Technique and Practice of the International Chamber of Commerce (Commission), which administers the UCP, has issued a formal opinion recognizing that parties who choose the UCP to govern a credit may choose a non-bank entity, — provided the entity is held to the same obligation and standard as if the LOC was issued by a bank. The UCC provides that an LOC issuer may be a bank or may be any other person.

3. **Overview of Federal – State Regulation of Financial Institutions**

a. **Dual Regulation** – Until 1863, only the states chartered banks. In that year, the federal National Bank Act created a national currency and a system of nationally chartered banks through which the federal government could conduct its business. The OCC was created to charter and regulate national banks. Would-be bankers could elect between a federal and a state banking charter. In 1913, the Federal Reserve Act required national banks to become members of the FRS. State-chartered banks could choose to do so, but few did. The federal Banking Act of 1933 (Glass-Steagall Act) created the FDIC and required national banks to obtain deposit insurance. State banks were permitted to obtain deposit insurance, and the vast majority of banks did so. Deposit insurance changed the nature of the process: While persons could still elect between a federal or state charter, neither would relieve a bank of federal oversight. In 1980, the federal Depository Institutions Deregulation and Monetary Control Act extended the benefits of Federal Reserve membership to all commercial banks and made all subject to the Federal Reserve’s reserve requirements. Commercial banks organized as national banks would be regulated by the OCC, and state-chartered banks would be supervised jointly by their state and either the FDIC or the Federal Reserve System.

b. **Regulatory Focus** – There are four components to U.S. banking regulation: 1) safety and soundness; 2) deposit insurance; 3) adequate capital; and 4) systemic risk. In the LOC context, we are predominantly concerned with safety and soundness and adequacy of capital. Safety and soundness refers to examining and regulating the probability of a firm’s default, and the magnitude of the losses that its owners and creditors would suffer if the firm defaulted. Capital means the amount by which an entity’s assets exceed its liabilities. The more capital a firm has, the greater its capacity to absorb losses and remain solvent. All federal regulators require the institutions they supervise to maintain specified minimum levels of capital—defined in various ways—to reduce failures and minimize losses to investors, customers and taxpayers when failures occur. U.S. banking capital standards are based on the Basel Accords, an international framework developed under the auspices of the Bank for International Settlements. The guiding principle of the Basel standards is that capital requirements should be risk-based. The riskier an asset, the more capital a bank should hold against possible losses. The Basel Accords provide two broad methodologies for calculating risk-based capital: 1) a standardized approach to credit risk determinations, based on external risk assessments (such as bond ratings); and 2) an alternative approach that relies on banks' internal risk models and rating systems. Adoption of the latter method—set out in the 2004 Basel II framework—in the United States has been slow, and thus far is limited to a few large banks. In July 2010, in response to the global financial crisis, the Basel Committee proposed a more stringent set of capital requirements, called Basel III.

c. **Banks and Non-Banks** (Banking Activities and Non-Banking Activities) – A bank is an entity “which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans. A non-bank is a financial institution that performs one but not both of these functions.”

4. **Identifying Banks and Non-Banks LOC Issuers in the U.S. and Their Regulation**

a. **OCC-Regulated Entities**

   (i) **National Banks** – A national bank is a commercial bank chartered by the U.S. government through the OCC. National banks help structure the financial system. They are members of the FRS as investors in its district Federal Reserve Banks, they facilitate the auction process of U.S. Treasury bonds, and they are members of the FDIC. Federal law very clearly provides that national banks and their operating subsidiaries may issue LOCs.

   (ii) **A Financial Subsidiary of a National Bank** – A national bank may control a financial subsidiary and may conduct, through that financial subsidiary, activities that are financial in nature, activities incidental to a financial activity and any activities that national banks may engage in directly. Activities are financial in nature or incidental to financial activity if defined as such under the federal Bank Holding Company Act (BHCA) (12 USC 1843(k)(4)) or by the Secretary of the Treasury. Section 1843 provides that an FHC may engage in any activity that the Board determines (by regulation or order) is
financial in nature or incidental to such financial activity or that is complementary to a financial activity. Section 1843 (k) (4) identifies categories of activities considered to be financial in nature. These include lending and engaging in any activity that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Under the authority of these sections, a national bank financial subsidiary could issue LOCs either because national banks may do so directly or because the Board has defined issuance of LOCs to be financial in nature in applicable regulations (12 CFR Section 225.86 and 12 CFR Section 225.28).18

(iii)  U.S. federal branches or agencies of foreign banks – The OCC may, subject to some restrictions, authorize a foreign bank engaged in a banking business outside the U.S. to establish one or more federal branches or agencies in any state. Under federal law, a U.S. federal branch or agency of a foreign bank has the same rights and privileges as a national bank doing business at the same location.19 Accordingly, the U.S. federal branch of a foreign bank may also issue LOCs. An additional ground for the conclusion is that the issuance of LOCs is deemed to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

(iv)  Federally chartered savings and loans – Most savings associations20 accept deposits and offer home loans. Savings and loan associations were regulated by the Office of Thrift Supervision (OTS)21 until the federal Dodd-Frank Wall Street Reform and Consumer Protection Act abolished the OTS and distributed its functions among the OCC, the FDIC and the FRS.22 Federal savings associations and federal savings banks are authorized to issue LOCs.23

b.  FDIC-Regulated Entities

(i)  Federally-insured depository institutions – The term “depository institution” refers to banks and savings associations. An insured depository institution is a bank or savings association whose deposits are insured by the FDIC. Insured depository institutions could be national banks, federal savings associations and federal branches, as well as state banks, state savings association and insured state branches.24 As discussed in this memorandum, all of these entities may issue LOCs.

(ii)  State banks that are not members of the FRS – Non-member banks of the FRS can only be state-chartered because all national banks have to be members of the FRS. Banks that are not members of the FRS are nevertheless subject to reserve requirements, which they maintain by placing a percentage of their deposits at a Federal Reserve Bank. But, they are not required to purchase stock in their district Federal Reserve Bank. The term “state bank” encompasses banks, banking associations, trust companies, savings banks, industrial banks (or similar depositories), cooperative banks or unincorporated banks whose deposits are insured by the FDIC.25 State banks may only engage in activities permissible for a national bank and their subsidiaries and, accordingly, can issue LOCs.26

(iii)  State-chartered thrift institutions – A state savings association includes building and loan associations, savings and loan associations, homestead associations, and cooperative banks. In general, a savings association chartered under state law is restricted to the same type of activities permissible for a federal savings association. Because LOC issuance is permitted to a federal savings association, it seems clear that state chartered savings associations can issue LOCs as well.27

c.  NCUA-Regulated Entities – A credit union is a cooperative chartered by the federal government or the state but owned by individuals. Federally chartered or federally insured credit unions are regulated by the NCUA, a full faith and credit agency of the U.S. government. The NCUA administers the National Credit Union Share Insurance Fund (NCUSIF), a deposit insurance fund separate from the FDIC’s that insures savings of federal credit and the majority of state-chartered credit union account holders. Federal credit unions include those chartered by the federal government and those with headquarters in Arkansas, Delaware, South Dakota, Wyoming or the District of Columbia. The definition of federally insured credit unions includes state-chartered credit unions. Credit unions are authorized to issue LOCs as an incidental power related to carrying out the business of lending.28
d. FRS Regulated Entities

(i) **BHC and its Subsidiaries** – A BHC is any company that has control over any bank or over any company that is or becomes a BHC.\(^{29}\) A large U.S. parent BHC may own domestic bank subsidiaries engaged in lending, deposit-taking and other activities, as well as nonbank and foreign subsidiaries engaged in a broader range of business activities. The largest BHCs may have more than 2,000 subsidiaries.\(^{30}\) BHCs and their subsidiaries are authorized to issue LOCs.\(^{31}\)

(ii) **FHC** – An FHC is a BHC that meets the requirements of section 1843 of the BHCA. The federal Gramm-Leach-Bliley Act (GLBA) amended the BHCA to enable a BHC to register as an FHC. Today, virtually all large BHCs are registered as FHCs.\(^{32}\) Under 1843 (a) BHCs are restricted to banking or managing or controlling banks and activities permitted under 12 USC 1843 (c) (8)—i.e., those determined to be so closely related to banking as to be a proper incident thereto. These activities are enumerated in 12 CFR § 225.28 and include issuing LOCs. But the question is what activities a BHC registered as an FHC may engage in as an FHC. 12 USC 1841 (p) defines an FHC as a BHC that meets the requirements of section 12 USC 1843(j) (1). 1843 (j)(1) specifies that a BHC may not use 1843 (k), which permits an FHC to engage in any activity that the Board determines by regulation or order to be financial in nature or incidental or complementary thereto. 1843 (l) (1) says that notwithstanding 1843 (k), a BHC may not engage in any activity other than those permissible for BHCs under 1843 (c) (8). Given that a Bank Holding Company can issue LOCs, under the definitional construct imposed by 1841 (p) and 1843 (l) (1) a BHC that elects to become an FHC and limits its activities as an FHC to those a BHC could engage in would be authorized to issue LOCs.\(^{33}\)

(iii) **SHC** – An SHC is a non-bank securities firm that owns or controls at least one registered broker-dealer.\(^{34}\) The federal Securities Exchange Act of 1934 (Exchange Act) is the primary federal legislation governing brokers and dealers in securities. With some exceptions, Section 15 of the Exchange Act requires registration of all broker-dealers that use interstate commerce or the facilities of any national securities exchange to buy or sell securities. The SHC was created to permit broker-dealers with foreign jurisdictions that require consolidated supervision to elect FRS supervision to meet the foreign jurisdiction’s requirement. The statute replaces the Elective Investment Bank Holding Company Framework developed and supervised by the SEC.\(^{35}\) Neither the nature of SHC operations, the statutory definition or the regulatory framework suggests that SHCs are authorized to engage in the issuance of LOCs. This assessment is supported by the statutory definition, which excludes insured banks, savings associations, their affiliate and foreign banks— institutions that are permitted to issue LOCs.\(^{36}\) (Note: With some exceptions, registered SHCs are supervised and regulated as BHCs,\(^{37}\) but this refers to supervisory matters. We could not find a basis to conclude that the intent is to link permissible activities of SHCs to those of BHCs as in other cases cited in this memorandum.\(^{38}\))

(iv) **SLHC** – an SLHC is a company that directly or indirectly controls a savings association or that controls an SLHC. A S&LHC and its (non-savings associations and non-service corporation subsidiaries) subsidiary savings associations may engage in those activities permitted to Bank Holding Company s pursuant to Board regulations promulgated under 12 USC 1843 4 (c) of the BHCA provided, the SLHC obtain prior approval of the Board. Section 4 (c) requires a BHC to provide prior written notice before engaging in a non-bank activity and the Board to determine whether the nonbank activity is closely related to banking and, hence, a proper incident thereto. (The same reasoning applies to a BHC that is also an FHC and wants to engage in an activity complementary to a financial activity under section 4(k) (1) (B)). The Board has determined that issuance of an LOC is so closely related to banking or managing or controlling banks as to be a proper incident thereto and, therefore, an approved non-bank activity for a BHC and its subsidiaries. SLHCs are authorized to issue LOCs.\(^{39}\)

(v) **U.S. branches and agencies of foreign banks** – A federal branch and a federal agency of a foreign bank are those established and operating under 12 USC 3102. Under federal law administered by the OCC (discussed above), a foreign bank engaged directly in a banking business outside the U.S. may, with the approval of the OCC, establish one or more federal branches or agencies in any state, and such entities have the same rights and duties that a national bank at the same location would have. (With respect to nonbanking activities, a foreign bank that maintains a branch or agency in a state is subject to the BHCA, 12 USC 1850 and chapter 22 in the same manner and to the same extent as BHCs.) A federal branch or agency, therefore, can issue LOCs because national banks can. The Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations prepared by Federal Reserve Board and Reserve Bank supervision personnel defines documentary LOCs which would not be necessary if a federal branch could not issue LOCs.\(^{40}\)

(vi) **Foreign branches of U.S. Banks** – Any national bank engaged in international operations through a foreign branch may engage in any activity in the foreign country permissible for a national bank in the U.S. and usual in connection with the
business of banking in the country where it transacts business and in any activity permissible under the Board’s Regulation K (12 CFR 211). Under Section 211.10, the Board may determine which activities are usual banking activities in the foreign jurisdiction. The Board has identified commercial and other banking activities, as well as financing (including commercial financing, consumer financing, mortgage banking, and factoring), as usual in connection with the transaction of banking or other financial operations abroad. As already discussed, national banks may issue LOCs in the U.S. as an activity incidental to banking, and it is difficult to envision that LOCs activity, which is so closely associated with international finance, would not be an activity usual for foreign banks to engage in, just as it is a usual activity for banks in the U.S.  

5. Conclusions – What emerges from the research is that banks (entities that accept deposits and make loans) may issue LOCs as part of the business of banking.

- National banks can issue LOCs as a general lending activity. Lending is part of the business of banking under paragraph Seven of the federal National Bank Act.
- National bank operating subsidiaries can issue LOCs on the same basis as national banks.
- Financial subsidiaries of national banks may issue LOCs and engage in any other activity that the national banks may engage in directly.
- Credit unions have incidental power to issue LOCs as an activity convenient or useful in carrying out the business of a credit union.
- Federal savings associations (the term includes federal savings associations and federal savings banks) can issue LOCs as a general banking activity.
- State banks (the term includes banks, banking associations, trust companies, savings banks, industrial banks or other banking institutions) that are members of the FRS may issue standby LOCs as a general banking activity.

Non-banks (entities that either accept deposits or make loans but not both) may issue LOCs because:

1) The entity is treated as a national bank, as a bank or as a non-bank for whom issuance of LOCs is a permissible activity.
- Financial subsidiaries of national banks may issue LOCs.
- Federal branches and agencies of a foreign bank have the same rights and privileges as a national bank.
- State savings associations (the term includes building and loan associations, savings and loan associations, homestead associations and cooperative banks) may engage in any activity permissible for a federal savings association.
- Insured state banks may engage in any activity permissible for a national bank.
- Insured bank subsidiaries may engage in any activity permissible for a national bank.
- SLHCs or subsidiaries that are not a savings associations may engage in activities permissible for a BHC.

2) A determination that LOC issuance is permissible because it is closely related to banking.
- FHCs may issue LOCs as an activity incidental to financial activity because such issuance is closely related to banking and a proper incident thereto.
- BHCs and its subsidiary may issue LOCs because they are an activity financial in nature which includes any activity the Board determines to be so closely related to banking to be a proper incident thereto.

3) A determination that LOC issuance is permissible because it is closely related to non-banking.
- BHCs and their subsidiaries (an extension of credit so closely related to banking or managing or controlling banks as to be a proper incident thereto).
- Financial subsidiary of a national bank. (Activities deemed permissible nonbanking activities include issuing LOCs, which is an extension of credit.)

4) A determination that LOC issuance is permissible because it is financial in nature.
- Financial subsidiaries of national banks.
- BHCs and their subsidiaries.
- FHCs. (Activities that are financial in nature include lending and any activity that the Board determines to be so closely related to banking to be a proper incident thereto.)
5) A determination that LOC issuance is permissible because it is permissible in the U.S. and is a usual banking activity in the foreign jurisdiction where the U.S. entity operates.
   - A national bank engaged in international operations through a foreign branch may engage in an activity in a foreign country permissible for a national bank in the U.S. and usual in that country as the business of banking and in any activity in a foreign country permissible by the Federal Reserve Board under Regulation K.

G:\DATA\Vos-tf\Meetings\2015\Feb.24, 2015\TaskForceConvertBanktoQUSFinInstList.docx
### Attachment One


<table>
<thead>
<tr>
<th>Regulatory Agency</th>
<th>Institutions Regulated</th>
<th>Emergency/Systemic Risk Powers</th>
<th>Other Notable Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve</td>
<td>Bank holding companies* and certain subsidiaries, financial holding companies, securities holding companies, savings and loan holding companies, and any firm designated as systematically significant by the FSOC State banks that are members of the Federal Reserve System, U.S. branches of foreign banks, and foreign branches of U.S. banks Payment, clearing, and settlement systems designated as systematically significant by the FSOC, unless regulated by SEC or CFTC</td>
<td>Lender of last resort to member banks (through discount window lending) In “unusual and exigent circumstances” the Fed may extend credit beyond member banks, for the purpose of providing liquidity to the financial system, but not to aid failing financial firms May initiate resolution process to shut down firms that pose a grave threat to financial stability (requires concurrence of 2/3 of the FSOC)</td>
<td></td>
</tr>
<tr>
<td>Office of the Comptroller of the Currency (OCC)</td>
<td>National banks, U.S. federal branches of foreign banks, federally chartered thrift institutions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Deposit Insurance Corporation (FDIC)</td>
<td>Federally-insured depository institutions, including state banks that are not members of the Federal Reserve System and state-chartered thrift institutions</td>
<td>After making a determination of systemic risk, the FDIC may invoke broad authority to use the deposit insurance funds to provide an array of assistance to depository institutions, including debt guarantees</td>
<td></td>
</tr>
<tr>
<td>National Credit Union Administration (NCUA)</td>
<td>Federally-chartered or insured credit unions</td>
<td>Serves as a liquidity lender to credit unions experiencing liquidity shortfalls through the Central Liquidity Facility</td>
<td>Operates a deposit insurance fund for credit unions, the National Credit Union Share Insurance Fund (NCUSIF)</td>
</tr>
</tbody>
</table>
Endnotes

1 Section 3. Asset or Reduction from Liability for Reinsurance Ceded by a Domestic Insurer to an Assuming Insurer not Meeting the Requirements of Section 2

An asset or a reduction from liability for the reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section 2 shall be allowed in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the ceding insurer, under a reinsurance contract with the assuming insurer as security for the payment of obligations thereunder, if the security is held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer; or, in the case of a trust, held in a qualified U.S. financial institution, as defined in Section 4B. This security may be in the form of: C. (1) Clean, irrevocable, unconditional letters of credit, issued or confirmed by a qualified U.S. financial institution, as defined in Section 4A …

Drafting Note: Providing for the continuing acceptability of letters of credit whose issuers were acceptable when the credit support facility was first obtained is intended to avoid abrupt interruptions in the acceptability of credit support arrangements that run for specific periods of time, and thus unnecessary disruptions in the marketplace, on account of the issuing (or confirming) institution’s subsequent failure to meet applicable standards of issuer acceptability (whether by virtue of a change in the issuing institution’s ability to qualify under the original standards or as a result of revisions to the applicable standards). The provision stipulates that letters of credit acceptable when first obtained will, in the event of the subsequent nonqualification of the issuing (or confirming) institution, continue to be acceptable as security until the account party and beneficiary would first have, in the normal course of business, an opportunity to replace the credit support facility. Source: Credit for Reinsurance Model Act (§785), 2012.

2 Section 4. Qualified U.S. Financial Institutions A. For purposes of Section 3C, a “qualified U.S. financial institution” means an institution that: (1) is organized or (in the case of a U.S. office of a foreign banking organization) licensed, under the laws of the United States or any state thereof; (2) is regulated, supervised and examined by U.S. federal or state authorities having regulatory authority over banks and trust companies; and (3) has been determined by either the commissioner or the SVO of the NAIC to meet such standards of financial condition and standing as are considered necessary and appropriate to regulate the quality of financial institutions whose letters of credit will be acceptable to the commissioner.

Drafting Note: The NAIC’s SVO maintains, on a current basis, a list of all U.S. financial institutions that have, upon application to the SVO, been determined to meet the eligibility standards of its Purposes and Procedures Manual. These standards, developed by the NAIC’s Letter of Credit (EX4) Study Group, make use of nationally recognized ratings services, and are more rigorous in the case of foreign banking organizations (whose standby letters of credit must be issued or confirmed by a qualified U.S. financial institution) than those that are applicable to domestic financial institutions whose standby letters of credit would be considered acceptable. Source: Model §785, 2012.

3 The Regulation of Financial Holding Companies, Robert Charles Clark, 92 Harv. L. Rev. 787, 796; 1978-1979


5 Uniform Commercial Code (1995) § 5-102. Definitions. (a) In this article: (2) "Applicant" means a person at whose request or for whose account a letter of credit is issued. The term includes a person who requests an issuer to issue a letter of credit on behalf of another if the person making the request undertakes an obligation to reimburse the issuer. (3) "Beneficiary" means a person who under the terms of a letter of credit is entitled to have its complying presentation honored. The term includes a person to whom drawing rights have been transferred under a transferable letter of credit. (9) "Issuer" means a bank or other person that issues a letter of credit, but does not include an individual who makes an engagement for personal, family, or household purposes. (10) "Letter of credit" means a definite undertaking that satisfies the requirements of Section 5-104 by an issuer to a beneficiary at the request for or the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

6 Uniform Commercial Code (1995) § 5-104. Formal Requirements. A letter of credit, confirmation, advice, transfer, amendment, or cancellation may be issued in any form that is a record and is authenticated (i) by a signature or (ii) in accordance with the agreement of the parties or the standard practice referred to in Section 5-108(e), § 5-102. Definitions. (a) In this article: (14) "Record" means information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form. § 5-108. Issuer's Rights and Obligations (e) An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. The issuer's observance of the standard practice is a matter of interpretation for the court. The court shall offer the parties a reasonable opportunity to present evidence of the standard practice.

Official Comment 6 to Section 5-102 – “The label on a document is not conclusive; certain documents labelled "guarantees" in accordance with European (and occasionally, American) practice are letters of credit. On the other hand, even documents that are labelled "letter of credit" may not constitute letters of credit under the definition in Section 5-102(a). When a document labelled a letter of credit requires the issuer to pay not upon the presentation of documents, but upon the determination of an extrinsic fact such as applicant's failure to perform … and where that condition appears on its face to be fundamental and would, if ignored, leave no obligation to the issuer under the document labelled letter of credit, the issuer's undertaking is not a letter of credit. It is probably some form of suretyship or other contractual arrangement and may be enforceable as such. … undertakings whose fundamental term requires an issuer to look beyond documents and beyond conventional reference to the clock, calendar, and practices concerning the form of various documents are not governed by Article 5. … Although Section 5-108(g) recognizes that certain nondocumentary conditions can be included in a letter of credit without denying the undertaking the status of letter of credit, that section does not apply to cases where the nondocumentary condition is fundamental to the issuer's obligation. … Note, however, that no particular phrase or label is necessary to establish a letter of credit. It is sufficient if the undertaking of the issuer shows that it is intended to be a letter of credit. In most cases the parties' intention will be indicated by a label on the undertaking itself indicating that it is a "letter of credit," but no such language is necessary …”
UCP Section A General Provisions and Definitions, Article 2 – Meaning of Credit – For the purposes of these Articles, the expressions Documentary Credits and Standby Letter(s) of Credit (hereinafter referred to as Credits mean any arrangement, however, named or described, whereby a Bank, (the “Issuing Bank”) acting at the request and on the instructions of a customer (the “Applicant”) on its own behalf, i. to make a payment to or to the order of a third party (the “Beneficiary) or is to accept and pay bills of exchanges (Drafts) drawn by the Beneficiary, or ii. Authorizes another bank to effect such payment, or to accept any pay such bills of exchange (Drafts) or iii. Authorizes another bank to negotiate against stipulated document(s) provided that the terms and conditions of the Credit are compiled with …

UCP Section A General Provisions and Definitions, Article 3 –Credits v. Contracts – Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfill and other obligation under the Credit, is not subject to claims or defenses by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.

7 UCC § 5-116. Choice of Law and Forum. (a) The liability of an issuer, nominated person, or adviser for action or omission is governed by the law of the jurisdiction chosen by an agreement … The jurisdiction whose law is chosen need not bear any relation to the transaction. (b) Unless subsection (a) applies, the liability of an issuer … is governed by the law of the jurisdiction in which the person is located … (c) Except as otherwise provided in this subsection, the liability of an issuer, nominated person, or adviser is governed by any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits, to which the letter of credit, confirmation, or other undertaking is expressly made subject … (emphasis added).

UCP Section A General Provisions and Definitions, Article 1 – The Uniform Customs and Practices for Documentary Credits … shall apply to all Documentary Credits … where they are incorporated into the text of the Credit …?”

8 The Uniform Customs and Practices for Documentary Credits (Publication No. 600) of the International Chamber of Commerce.

9 UCC § 5-103. Scope. “… (c) With the exception of this subsection, subsections (a) and (d), Sections 5-102(a)(9) and (10), 5-106(d), and 5-114(d), and except to the extent prohibited in Sections 1-302 and 5-117(d), the effect of this article may be varied by agreement or by a provision stated or incorporated by reference in an undertaking. A term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article. (d) Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.”

10 International Chamber of Commerce, Department of Policy and Business Practices, Commission on Banking Technique and Practice, “When a non-bank issues a letter of credit”, Oct. 30, 2002. The Commission recognized the prevailing assumption “… that banks have the operational expertise to handle issuance and presentation under letters of credit in a professional manner, that they have the tradition of independence from the underlying transaction which is the basis of the commercial reputation of the letter of credit, and that in virtually all countries banks are specially regulated with a view toward protecting those who rely on their undertakings.” Nevertheless, the Commission noted that the UCP is a set of voluntary rules of practice, not a legislative act and as such parties may agree to vary which provisions will and will not apply to their agreement. Accordingly, the decision to use a non-bank as issuer of an LOC is a permitted modification. The Commission also noted that even in countries where only financial institutions can issue letters of credit, it is not clear that banks are the only type of financial institution.

11 12 USC Section 1815. Deposit insurance (a) Application to Corporation required (1) In general Except as provided in paragraphs (2) and (3), any depository institution which is engaged in the business of receiving deposits other than trust funds (as defined in section 1813(p) of this title), upon application to and examination by the Corporation and approval by the Board of Directors, may become an insured depository institution. (2) Interim depository institutions. In the case of any interim Federal depository institution that is chartered by the appropriate Federal banking agency and will not open for business, the depository institution shall be an insured depository institution upon the issuance of the institution’s charter by the agency. (3) Application and approval not required in cases of continued insurance Paragraph (1) shall not apply in the case of any depository institution whose insured status is continued pursuant to section 1814 of this title. (4) Review requirements In reviewing any application under this subsection, the Board of Directors shall consider the factors described in section 1816 of this title in determining whether to approve the application for insurance. (b) Foreign branch nonmember banks; matters considered Subject to the provisions of this chapter and to such terms and conditions as the Board of Directors may impose, any branch of a foreign bank, upon application by the bank to the Corporation, and examination by the Corporation of the branch, and approval by the Board of Directors, may become an insured branch. Before approving any such application, the Board of Directors shall give consideration to …


15 The OCC was created in 1863 as part of the Department of Treasury to supervise federally chartered banks (“federal” banks) and to replace the circulation of state bank notes with a single national currency (Chapter 106, 13 STAT. 99). The OCC regulates a wide variety of financial functions, but only for federally chartered banks. Congressional Research Service, Who Regulates Whom? An Overview of U.S. Financial Supervision, Mark Jickling and Edward V. Murphy, Dec. 8, 2010.
10 12 USC § 21 - Formation of national banking associations; incorporators; articles of association - Associations for carrying on the business of banking under title 62 of the Revised Statutes may be formed by any number of natural persons, not less in any case than five. They shall enter into articles of association, which shall specify in general terms the object for which the association is formed, and may contain any other provisions, not inconsistent with law, … These articles shall be signed by the persons uniting to form the association, and a copy of them shall be forwarded to the Comptroller of the Currency, to be filed and preserved in his office.

12 USC § 24. Corporate powers of associations - Upon duly making and filing articles of association and an organization certificate the [a national banking] association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power – … Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title …

11 12 CFR 7.1016 - Independent undertakings to pay against documents, (a) General authority. A national bank may issue and commit to issue letters of credit and other independent undertakings within the scope of the applicable laws or rules of practice recognized by law. Under such letters of credit and other independent undertakings, the bank’s obligation to honor depends upon the presentation of specified documents and not upon nondocumentary conditions or resolution of questions of fact or law at issue between the applicant and the beneficiary. A national bank may also confirm or otherwise undertake to honor or purchase specified documents upon their presentation under another person’s independent undertaking within the scope of such laws or rules.

The authority to issue letters of credit is identified in an OCC Manual as payment services within the general banking activities of a national bank. “National banks may engage in activities that are part of, or incidental to, the business of banking, or are otherwise authorized for a national bank … Lending, in General. A national bank and its operating subsidiaries may make, purchase, sell, service, or warehouse house loans or other extensions of credit for its own or another’s account, including consumer loans, credit card loans, commercial loans, residential mortgage loans, commercial mortgage loans, and standby letters of credit. 12 USC 24 (Seventh), 371; 12 CFR 5.34 … Payment Services … Letters of Credit. National banks may issue and commit to issue letters of credit and other independent undertakings within the scope of such laws or rules. …

The authority to issue letters of credit is identified in an OCC Manual as payment services within the general banking activities of a national bank. “National banks may engage in activities that are part of, or incidental to, the business of banking, or are otherwise authorized for a national bank … Lending, in General. A national bank and its operating subsidiaries may make, purchase, sell, service, or warehouse house loans or other extensions of credit for its own or another’s account, including consumer loans, credit card loans, commercial loans, residual mortgage loans, commercial mortgage loans, and standby letters of credit. 12 USC 24 (Seventh), 371; 12 CFR 5.34 … Payment Services … Letters of Credit. National banks may issue and commit to issue letters of credit and other independent undertakings within the scope of such laws or rules.
12 CFR 28.13 - Permissible activities. (a) Applicability of laws—(1) General. Except as otherwise provided by the IBA, other Federal laws or regulations, or otherwise determined by the OCC, the operations of a foreign bank at a Federal branch or agency shall be conducted with the same rights and privileges and subject to the same duties, restrictions, penalties, liabilities, conditions, and limitations that would apply if the Federal branch or agency were a national bank operating at the same location.

12 CFR 7.1016 - Independent undertakings to pay against documents. (a) General authority. A national bank may issue and commit to issue letters of credit and other independent undertakings within the scope of the applicable laws or rules of practice recognized by law. Under such letters of credit and other independent undertakings, the bank’s obligation to honor depends upon the presentation of specified documents and not upon non documentary conditions or resolution of questions of fact or law at issue between the applicant and the beneficiary. A national bank may also confirm or otherwise undertake to honor or purchase specified documents upon their presentation under another person’s independent undertaking within the scope of such laws or rules. See also, OCC, Activities Permissible for a National Bank, 2011 Annual Edition. The authority to issue letters of credit is identified as a lending activity under the General Banking Activities of a national bank.

20 12 U.S. Code § 1813 - Definitions - As used in this chapter— (b) Definition of savings associations and related terms (1) Savings association - The term “savings association” means— (A) any Federal savings association; (B) any State savings association; and (C) any corporation (other than a bank) that the Board of Directors and the Comptroller of the Currency jointly determine to be operating in substantially the same manner as a savings association. (2) Federal savings association - The term “Federal savings association” means any Federal savings association or Federal savings bank which is chartered under section 1464 of this title. (3) State savings association. The term “State savings association” means—(A) any building and loan association, savings and loan association, or homestead association; or (B) any cooperative bank (other than a cooperative bank which is a State bank as defined in subsection (a)(2) of this section), which is organized and operating according to the laws of the State (as defined in subsection (a)(3) of this section) in which it is chartered or organized.

21 The OTS was created in 1989 during the savings and loan crisis (P.L. 101-73, 103 STAT. 183), as successor to the Federal Savings and Loan Insurance Corporation (FSLIC), created in 1934 and administered by the Federal Home Loan Bank Board. The OTS had responsibility for federal savings associations and their holding companies and also supervised federally insured state savings associations. Congressional Research Service, Who Regulates Whom? An Overview of U.S. Financial Supervision, Mark Jillick and Edward V. Murphy; December 8, 2010.

22 12 USC § 1464. Federal savings associations - (a) In general - In order to provide thrift institutions for the deposit of funds and for the extension of credit for homes and other goods and services, the Director is authorized, under such regulations as the Director may prescribe— (1) to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as Federal savings associations (including Federal savings banks), and (2) to issue charters therefor, giving primary consideration of the best practices of thrift institutions in the United States. … (b) Deposits and related powers - (1) Deposit accounts (A) Subject to the terms of its charter and regulations of the Director, a Federal savings association may issue letters of credit and may include passbooks, certificates, or other evidence of accounts. …

23 12 C.F.R. § 160.50 - Letters of credit and other independent undertakings—authority. A Federal savings association may issue letters of credit and may issue such other independent undertakings as are approved by the OCC, subject to the restrictions in § 160.120.

24 Federal Deposit Insurance Act 12 USC § 1813. Federal Deposit Insurance Act 12 USC § 1813 (c) Definitions Relating to Depository Institutions. (1) Depository Institutions.—The term “depository institution” means any bank or savings association, (2) … The term “insured depository institution” means any bank or savings association the deposits of which are insured by the Corporation pursuant to this Act. … (4) … The term “Federal depository institution” means any national bank, any Federal savings association, and any Federal branch. (5) … The term “State depository institution” means any State bank, any State savings association, and any insured branch which is not a Federal branch.

25 Federal Deposit Insurance Act, 12 USC Section 1813 As used in this chapter — (a) … The term “bank”— (A) means any national bank and State bank, and any Federal branch and insured branch; and (B) includes any former savings association. (2) … The term “State bank” means any bank, banking association, trust company, savings bank, industrial bank (or similar depository institution which the Board of Directors finds to be operating substantially in the same manner as an industrial bank), or other banking institution which—(A) is engaged in the business of receiving deposits, other than trust funds (as defined in this section); and (B) is incorporated under the laws of any State or which is operating under the Code of Law for the District of Columbia, including any cooperative bank or other unincorporated bank the deposits of which were insured by the Corporation on the day before the date of the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. (3) … The term “State” means any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, the Trust Territory of the Pacific Islands, the Virgin Islands, and the Northern Mariana Islands.

26 12 U.S. Code § 1831a - Activities of insured State banks - (a) Permissible activities - (1) In general - … an insured State bank may not engage as principal in any type of activity that is not permissible for a national bank unless— (A) the Corporation has determined that the activity would pose no significant risk to the Deposit Insurance Fund; and (B) the State bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate Federal banking agency.

12 CFR Part 362 - Subpart A—Activities of Insured State Banks – 362.1 Purpose and scope (a) This subpart …implements the provisions of section 24 of the Federal Deposit Insurance Act (12 U.S.C. 1831a) that restrict and prohibit insured state banks and their subsidiaries from engaging in activities and
investments that are not permissible for national banks and their subsidiaries. The phrase "activity permissible for a national bank" means any activity authorized for national banks under any statute including the National Bank Act (12 U.S.C. 21 et seq.), as well as activities recognized as permissible for a national bank in regulations, official circulars, bulletins, orders or written interpretations issued by the Office of the Comptroller of the Currency (OCC).

12 CFR 7.1016 - Independent undertakings to pay against documents. (a) General authority. A national bank may issue and commit to issue letters of credit and other independent undertakings within the scope of the applicable laws or rules of practice recognized by law. Under such letters of credit and other independent undertakings, the bank's obligation to honor depends upon the presentation of specified documents and not upon nondocumentary conditions or resolution of questions of fact or law at issue between the applicant and the beneficiary. A national bank may also confirm or otherwise undertake to honor or purchase specified documents upon their presentation under another person's independent undertaking within the scope of such laws or rules. See also, OCC, Activities Permissible for a National Bank, 2011 Annual Edition. The authority to issue letters of credit is identified as a lending activity under the General Banking Activities of a national bank.

27 Federal Deposit Insurance Corporation Act, 12 USC Section 1813 (b) Definitions ... (1) ... The term "savings association" means-- (A) any Federal savings association; (B) any State savings association; and (C) any corporation (other than a bank) that the Board of Directors and the Comptroller of the Currency jointly determine to be operating in substantially the same manner as a savings association. (2) ... The term "Federal savings association" means any Federal savings association or Federal savings bank which is chartered under section 1464 of this title. (3) ... The term "State savings association" means-- (A) any building and loan association, savings and loan association, or homestead association; or (B) any cooperative bank (other than a cooperative bank which is a State bank as defined in subsection (a) (2)), which is organized and operating according to the laws of the State (as defined in subsection (a)(3)) in which it is chartered or organized.

12 USC Section 1831e - Activities of savings associations (a) In general - ... a savings association chartered under State law may not engage as principal in any type of activity ... not permissible for a Federal savings association unless ... (b) Differences of magnitude between State and Federal powers Notwithstanding subsection (a)(1) of this section, if an activity (other than an activity described in section 1464(c)(2)(B) of this title) is permissible for a Federal savings association, a savings association chartered under State law may engage as principal in that activity in an amount greater than the amount permissible for a Federal savings association if ...
12 CFR 721.3 - What categories of activities are preapproved as incidental powers necessary or requisite to carry on a credit union's business?
The categories of activities in this section are preapproved as incidental to carrying on your business under § 721.2. The examples of incidental powers activities within each category are provided in this section as illustrations of activities permissible under the particular category, not as an exclusive or exhaustive list ... (b) Loan-related products. Loan-related products are the products, activities or services you provide to your members in a lending transaction that protect you against credit-related risks or are otherwise incidental to your lending authority. These products or activities may include debt cancellation agreements, debt suspension agreements, letters of credit and leases ...

29 12 USC § 1841. Definitions (a)(1) Except as provided in paragraph (5) of this subsection, “bank holding company” means any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter. (2) Any company has control over a bank or over any company if— (A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.


31 12 CFR § 225.28 - List of permissible nonbanking activities. (a) Closely related nonbanking activities. The activities listed in paragraph (b) of this section are so closely related to banking or managing or controlling banks as to be a proper incident thereto, and may be engaged in by a bank holding company or its subsidiary in accordance with the requirements of this regulation. (b) Activities determined by regulation to be permissible—(1) Extending credit and servicing loans. Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others ...


33 12 U.S. Code § 1843 - Interests in nonbanking organizations (a) Ownership or control of voting shares of any company not a bank; engagement in activities other than banking. Except as otherwise provided in this chapter, no bank holding company shall— (1) after May 9, 1956, acquire direct or indirect ownership or control of any voting shares of any company which is not a bank, or (2) after two years from the date as of which it becomes a bank holding company, ... after December 31, 1978, or, ... as a result of the enactment of the Bank Holding Company Act Amendments of 1970, a bank holding company on December 31, 1970, after December 31, 1980, ... engage in any activities other than (A) those of banking or of managing or controlling banks and other subsidiaries authorized under this chapter or of furnishing services to or performing services for its subsidiaries, and (B) those permitted under paragraph (8) of subsection (c) of this section subject to all the conditions specified in such paragraph or in any order or regulation issued by the Board under such paragraph:

12 USC 1843 (c) Exemptions ... The prohibitions in this section shall not apply to ... (8) shares of any company the activities of which had been determined by the Board ... to be so closely related to banking as to be a proper incident thereto (subject to such terms and conditions contained in such regulation or order, unless modified by the Board);

12 CFR § 225.28 - List of permissible nonbanking activities. (a) Closely related nonbanking activities. The activities listed in paragraph (b) of this section are so closely related to banking or managing or controlling banks as to be a proper incident thereto, and may be engaged in by a bank holding company or its subsidiary in accordance with the requirements of this regulation. (b) Activities determined by regulation to be permissible—(1) Extending credit and servicing loans. Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others ...

12 USC 1843 (p) - Financial Holding Company.— For purposes of this chapter, the term “financial holding company” means a bank holding company that meets the requirements of section 1843(f)(1) of this title.

12 USC 1843 (k): Engaging in activities that are financial in nature (1) In general Notwithstanding subsection (a) of this section, a financial holding company may engage in any activity, and may acquire and retain the shares of any company engaged in any activity, that the Board, in accordance with paragraph (2), determines (by regulation or order) — (A) to be financial in nature or incidental to such financial activity; or (B) is complementary to a financial activity ... (4) Activities that are financial in nature - For purposes of this subsection, the following activities shall be considered to be financial in nature: (A) Lending ... (B) Insuring, guaranteeing, or indemnifying ... (F) Engaging in any activity that the Board has determined, by order or regulation ... to be so closely related to banking or managing or controlling banks as to be a proper incident thereto ...

12 CFR 225.86 - What activities are permissible for any financial holding company? The following activities are financial in nature or incidental to a financial activity: (a) Activities determined to be closely related to banking. (1) Any activity that the Board had determined by regulation prior to November 12, 1999, to be so closely related to banking as to be a proper incident thereto, subject to the terms and conditions contained in this part, unless modified by the Board. These activities are listed in § 225.28.

1843(f)(1): Conditions for engaging in expanded financial activities (1) In general - Notwithstanding subsection (k), (n), or (o) of this section, a bank holding company may not engage in any activity ... other than activities permissible for any bank holding company under subsection (c)(8) of this section, unless ... and (C) the bank holding company has filed with the Board— (i) a declaration that the company elects to be a financial holding company to engage in activities ... that were not permissible for a bank holding company to engage in or acquire before the enactment of the Gramm-Leach-Bliley Act ...

24 12 USC § 1850a - Securities holding companies (a) Definitions In this section—(1) the term “associated person of a securities holding company” means a person directly or indirectly controlling, controlled by, or under common control with, a securities holding company; (2) the term “foreign bank” has the same meaning as in section 3101(7) of this title; (3) the term “insured bank” has the same meaning as in section 1813 of this title; (4) the term “securities holding company”— (A) means— (i) a person (other than a natural person) that owns or controls 1 or more brokers or dealers registered with the Commission; and (ii) the associated persons of a person described in clause (i); and (B) does not include a person that is— (i) a nonbank financial company supervised by the Board under title I; (ii) an insured bank (other than an institution described in subparagraphs 2(D), (E), or (H) of section 3(c)(2) of the
Bank Holding Company Act of 1956 has provisions for supervised securities holding companies. The Board anticipates that there will be a period of time before the Board becomes fully acquainted with supervised securities holding companies. The Board expects to understand the supervision and regulation of securities holding companies once it becomes familiar with the supervised securities holding companies.

The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others. (B) Exception for certain bank activities. A bank shall not be considered to be a broker because the bank engages in any one or more of the following activities under the conditions described...

Dealer— (A) In general. The term "dealer" means any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise. (B) Exception for person not engaged in the business of dealing. The term "dealer" does not include a person that buys or sells securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.


See the underlined text in 12 USC Section 1850a above. The definitions corresponding to the underlined exclusions in 12 USC Section 1841 (c) (2) are identified below. (c) BANK DEFINED... Except as provided in paragraph (2), the term “bank” means any of the following: (A) An insured bank as defined in section 3(h) of the Federal Deposit Insurance Act [12 U.S.C. 1813(b)]. (B) An institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands which both—(i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (ii) is engaged in the business of making commercial loans. (2) EXCEPTIONS. The term “bank” does not include any of the following: (D) An institution that functions solely in a trust or fiduciary capacity, if—(i) all or substantially all of the deposits of such institution are in trust funds and are received in a bona fide fiduciary capacity; (ii) no deposits of such institution which are insured by the Federal Deposit Insurance Corporation are offered or marketed by or through an affiliate of such institution; (iii) such institution does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (iv) does not accept any savings and time deposit of less than $100,000; (v) maintains only one office that accepts deposits; and (H) An industrial loan company, industrial bank, or other similar institution which is—(i) an institution organized under the laws of a State which, on March 5, 1987, had in effect or had under consideration in such State’s legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act [12 U.S.C. 1811 et seq.];—(I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties; (II) which has total assets of less than $50,000,000; or (III) the control of which is not acquired by any company after August 10, 1987; or (ii) an institution which does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987, except that this subparagraph shall cease to apply to any institution which permits any overdraft (including any intraday overdraft), or which incurs any such overdraft in such institution’s account at a Federal Reserve bank, on behalf of an affiliate if such overdraft is not the result of an inadvertent computer or accounting error that is beyond the control of both the institution and the affiliate, or that is otherwise permissible for a bank controlled by a company described in section 1843(f)(1) of this title.

12 CFR § 241.3 Registration as a supervised securities holding company. (a) Registration. (1) Filing Requirement. A securities holding company may elect to register to become a supervised securities holding company by filing the appropriate form with the responsible Reserve Bank. ... (2) Supervision and regulation of securities holding companies. (i) Upon an effective registration and except as otherwise provided by order of the Board, a supervised securities holding company shall be treated, and shall be subject to supervision and regulation by the Board, as if it were a bank holding company, or as otherwise appropriate to protect the safety and soundness of the supervised securities holding company and address the risks posed by such company to financial stability. (ii) The provisions of section 4 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) do not apply to a supervised securities holding company.

12 USC Section 1467a – Regulation of holding companies ... (D) ... Except as provided in clause (ii), the term "savings and loan holding company" means any company that directly or indirectly controls a savings association or that controls any other company that is a savings and loan holding company. (ii) ... The term "savings and loan holding company" does not include—(I) a bank holding company ... registered under, ... (the 12 U.S.C. 1841 et seq.), or to any company directly or indirectly controlled by such company (other than a savings association); (II) a company that controls a savings association that functions solely in a trust or fiduciary capacity as described in ... (12 U.S.C. 1841(c)(2)(D)); ...
12 CFR § 584.2 Prohibited activities. (b) Unrelated business activity. No savings and loan holding company or subsidiary thereof that is not a savings association shall commence any business activity at any time, ... subject to the limitations of this paragraph (b), except (in either case) (6) Any other activity: (ii) Is set forth in § 584.2-1 of this part, subject to the limitations therein;

12 CFR § 584.2-1 - Prescribed services and activities of savings and loan holding companies. (a) General. For the purpose of § 584.2(b)(6)(b)(iii) of this part, the activities set forth in paragraph (b) of this section are ... permissible ... activities for savings and loan holding companies or subsidiaries thereof that are neither savings associations ... (b) Prescribed services and activities. Subject to the provisions of paragraph (c) of this section, a savings and loan holding company subject to restrictions on its activities pursuant to § 584.2(b) of this part, or a subsidiary thereof which is neither a savings association ... may ... engage in the following activities: ... (1) Originating, purchasing, selling and servicing any of the following: (i) Loans, and participation interests in loans, ... (iii) Manufactured home chattel paper ... (ii) Loans, with or without security, for the altering, repairing, improving, equipping or furnishing of any residential real estate; (iv) Educational loans; and (v) Consumer loans ... 

12 CFR § 584.2-2 Permissible bank holding company activities of savings and loan holding companies. (a) General. For purposes of § 584.2(b)(6)(i) of this part, the services and activities permissible for bank holding companies pursuant to regulations that the Board ... has promulgated pursuant to section 4(c) of the Bank Holding Company Act are permissible for savings and loan holding companies, or subsidiaries thereof that are neither savings associations ...: Provided, That no savings and loan holding company shall commence any activity described in this paragraph (a) without the prior approval of this Office ... 

§ 584.2 Prohibited activities. (b) Unrelated business activity. No savings and loan holding company or subsidiary thereof that is not a savings association ... shall commence any business activity at any time, ... that is subject to the limitations of this paragraph (b), except (in either case) the following; (6) Any other activity: (i) That the Board of Governors of the Federal Reserve System has permitted for bank holding companies pursuant to regulations promulgated under section 4(c) of the Bank Holding Company Act;

12 U.S.C. § 3101 - Definitions - For the purposes of this chapter— (3) “branch” means any office or any place of business of a foreign bank located in any State of the United States at which deposits are received; (5) “Federal agency” means an agency of a foreign bank established and operating under section 3102 of this title; (6) “Federal branch” means a branch of a foreign bank established and operating under section 3102 of this title;

12 U.S.C. § 3102 - Scope. This subpart applies to all Federal branches and agencies of foreign banks. Nothing in the OCC’s rules relieves a Federal branch or agency shall be conducted with the same rights and privileges as a national bank at the same location and shall be subject to all the same duties, restrictions, penalties, liabilities, conditions, and limitations that would apply under the National Bank Act to a national bank doing business at the same location, ... 

12 U.S.C. § 3106 - Nonbanking activities of foreign banks - (a) Applicability of Bank Holding Company Acts - Except as otherwise provided in this section (1) any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary shall be subject to the provisions of the Bank Holding Company Act of 1956 [12 U.S.C. 1841 et seq.], and to section 1850 of this title and chapter 22 of this title in the same manner and to the same extent that bank holding companies are subject to such provisions.

12 C.F.R. 28.10 Authority, purpose, and scope. (a) Authority. This subpart is issued pursuant to the authority in the International Banking Act of 1978 (IBA), 12 U.S.C. 3101 et seq., and 12 U.S.C. 93a. (b) Purpose—Purpose and scope. This subpart implements the IBA pertaining to the licensing, supervision, and operations of Foreign branches and agencies in the United States. For corporate procedures pertaining to Federal branches and agencies, refer to 12 CFR part 5. (c) Scope. This subpart applies to all Federal branches and agencies of foreign banks. Nothing in the OCC’s rules relieves a Federal branch or agency from complying with requirements that are imposed by the FRB under Regulation K (12 CFR part 211) or otherwise imposed in accordance with applicable law.

12 C.F.R. 28.13 - Permissible activities. (a) Applicability of laws—(1) General. Except as otherwise provided by the IBA, other Federal laws or regulations, or otherwise determined by the OCC, the operations of a foreign bank at a Federal branch or agency shall be conducted with the same rights and privileges and subject to the same duties, restrictions, penalties, liabilities, conditions, and limitations that would apply if the Federal branch or agency were a national bank operating at the same location. (2) Parent foreign bank senior management approval. Unless otherwise provided by the OCC, any provision in law, regulation, policy, or procedure that requires a national bank to obtain the approval of its board of directors will be deemed to require a Federal branch or agency to obtain the approval of parent foreign bank senior management. (b) Management of shell branches—(1) Federal branches and agencies. A Federal branch or agency of a foreign bank shall not manage, through an office of the foreign bank that is located outside the United States and that is managed or controlled by that Federal branch or agency, any type of activity that a United States bank is not permitted to manage at any branch or subsidiary of the United States bank that is located outside the United States. (2) Activities managed in foreign branches or subsidiaries of United States banks. The types of activities referred to in paragraph (b)(1) of this section include the types of activities authorized to a United States bank by state or Federal charters, regulations issued by chartering or regulatory authorities, and other United States banking laws. However, United States procedural or quantitative requirements that may be applicable to the conduct of those activities by United States banks do not apply. (c) Additional guidance regarding permissible activities. For purposes of section 7(h) of the IBA, 12 U.S.C. 3105(h), the OCC may issue opinions, interpretations, or rulings regarding permissible activities of Federal branches.

12 C.F.R. 7.1016 - Independent undertakings to pay against documents. (a) General authority. A national bank may issue and commit to issue letters of credit and other independent undertakings within the scope of the applicable laws or rules of practice recognized by law. Under such letters of credit and other independent undertakings, the bank's obligation to honor depends upon the presentation of specified documents and not upon non documentary conditions or resolution of questions of fact or law at issue between the applicant and the beneficiary. A national bank may also confirm or otherwise undertake to honor or purchase specified documents upon their presentation under another person's independent undertaking within the scope of such laws or rules. See also, OCC, Activities Permissible for a National Bank, 2011 Annual Edition. The authority to issue letters of credit is identified as a lending activity under the General Banking Activities of a national bank.
Section 3320.1, Letters of Credit, Branch and Agency Examination Manual, September 1997 (Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations prepared by) Federal Reserve Board and Reserve Bank Supervision Personnel). The Manual defines commercial documentary letters of credit as issued by a bank (issuing bank) on behalf of its customer (account party), a buyer of merchandise, to a seller (beneficiary), authorizing the seller to draw drafts up to a stipulated amount, under specified terms and undertaking to provide eventual payment for drafts drawn. The beneficiary will be paid when the terms of the letter of credit are met and the required supporting documents are submitted to the paying or negotiating bank. A standby letter of credit provides for payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the issuing bank’s customer) upon the presentation of a draft or the documentation, as required in the letter of credit. Although a standby letter of credit may arise from a commercial transaction, it is usually not linked directly to the shipment of goods from seller to buyer. For reporting purposes, standby letters of credit are shown as contingent liabilities in the branch’s Report of Assets and Liabilities. Depending on any applicable state and federal laws and regulations, standby letters of credit may be subject to prudential limitations.

12 CFR 28.1 Authority, purpose, and scope. (a) Authority. This subpart is issued pursuant to 12 U.S.C. 1 et seq., 24 (Seventh), 93a, and 602. (b) Purpose. This subpart … clarifies permissible foreign activities of national banks. (c) Scope. This subpart applies to any national bank that engages in international operations through a foreign branch, or acquires an interest in an Edge corporation, Agreement corporation, foreign bank, or certain other foreign organizations.

12 CFR 28.2 Definitions. For purposes of this subpart: (c) Foreign bank means an organization that: (1) Is organized under the laws of a foreign country; (2) Engages in the business of banking; (3) Is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations; (4) receives deposits to a substantial extent in the regular course of its business; and (5) Has the power to accept demand deposits. (d) Foreign branch means an office of a national bank (other than a representative office) that is located outside the United States at which banking or financing business is conducted. (e) Foreign country means one or more foreign nations, and includes the overseas territories, dependencies, and insular possessions of those nations and of the United States, and the Commonwealth of Puerto Rico.

12 CFR 28.4 Permissible activities. (a) General. Subject to the applicable approval process, if any, a national bank may engage in any activity in a foreign country that is: (1) Permissible for a national bank in the United States; and (2) Usual in connection with the business of banking in the country where it transacts business. (b) Additional activities. In addition to its general banking powers, a national bank may engage in any activity in a foreign country that is permissible under the FRB’s Regulation K, 12 CFR part 211.

12 CFR 211.3 - Foreign branches of U.S. banking organizations. (a) General—(1) Definition of banking organization. For purposes of this section, a banking organization is defined as a member bank and its affiliates. (2) A banking organization is considered to be operating a branch in a foreign country if it has an affiliate that is a member bank, Edge or agreement corporation, or foreign bank that operates an office (other than a representative office) in that country. (3) For purposes of this subpart, a foreign office of an operating subsidiary of a member bank shall be treated as a foreign branch of the member bank and may engage only in activities permissible for a branch of a member bank. (4) At any time upon notice, the Board may modify or suspend branching authority conferred by this section with respect to any banking organization. (b) (1) Establishment of foreign branches. (i) Foreign branches may be established by any member bank having capital and surplus of $1,000,000 or more, an Edge corporation, an agreement corporation, any subsidiary the shares of which are held directly by the member bank, or any other subsidiary held pursuant to this subpart.

12 CFR Section 3320.4 Permissible activities and investments of foreign branches of member banks. (a) Permissible activities and investments. In addition to its general banking powers, and to the extent consistent with its charter, a foreign branch of a member bank may engage in the following activities … so far as is usual in connection with the business of banking in the country where it transacts business: (b) Other activities. With the Board’s prior approval, engage in other activities that the Board determines are usual in connection with the transaction of the business of banking in the places where the member bank’s branches transact business.

12 CFR 211.10 Permissible activities abroad. (a) Activities usual in connection with banking. The Board has determined that the following activities are usual in connection with the transaction of banking or other financial operations abroad: (1) Commercial and other banking activities; (2) Financing, including commercial financing, consumer financing, mortgage banking, and factoring, …

12 U.S. Code § 321 - Application for membership. Any bank incorporated by special law of any State,operating under the Code of Law for the District of Columbia, or organized under the general laws of any State or of the United States, … desiring to become a member of the Federal Reserve System, may make application to the Board of Governors of the Federal Reserve System, under such rules and regulations as it may prescribe, for the right to subscribe to the stock of the Federal Reserve bank organized within the district in which the applying bank is located. Such application shall be for the same amount of stock that the applying bank would be required to subscribe to as a national bank … The Board of Governors of the Federal Reserve System, subject to the provisions of this chapter and to such conditions as it may prescribe pursuant thereto may permit the applying bank to become a stockholder of such Federal Reserve bank …

12 CFR 208.1 Authority, purpose, and scope. (a) Authority. Subpart A of Regulation H (12 CFR part 208, subpart A) is issued by the Board … Under 12 U.S.C. 24, 36; sections 9, 11, 21, 25 and 25A of the Federal Reserve Act (12 U.S.C. 321–338a, 248(a), 248(c), 481–486, 601 and 611); sections 1814, 1816, 1818, 1831o, 1831p–1, 1831r–1 and 1835a of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1814, 1816, 1818, 1831o, 1831p–1, 1831r–1, and 1835); and 12 U.S.C. 3906–3909. (b) Purpose and scope of part 208. The requirements of this part 208 govern State member banks and state banks applying for admission to membership in the Federal Reserve System (System) under section 9 of the Federal Reserve Act (Act), except for § 208.7, which also applies to certain foreign banks licensed by a State. … (c) Purpose and scope of subpart A. This subpart A describes the eligibility requirements for membership of state chartered banking institutions in the System, the general conditions imposed upon members, including capital and dividend requirements, as well as the requirements for establishing and maintaining branches.

12 CFR 208.2 Definitions. For the purposes of this part: (c) Branch. (1) Branch means any branch bank, branch office, branch agency, additional office, or any branch place of business that receives deposits, pays checks, or lends money. A branch may include a temporary, seasonal, or mobile facility that meets these criteria. (g) State member bank or member bank means a state bank that is a member of the Federal Reserve System.

© 2015 National Association of Insurance Commissioners
12 CFR 208.3 Application and conditions for membership in the Federal Reserve System. (a) Applications for membership and stock. (1) State banks applying for membership in the Federal Reserve System shall file with the appropriate Federal Reserve Bank an application for membership in the Federal Reserve System and for stock in the Reserve Bank, in accordance with this part …

Subpart B—Investments and Loans

12 CFR 208.20 Authority, purpose, and scope. … (b) Purpose and scope. This subpart B describes certain investment limitations on member banks, statutory requirements for amortizing losses on agricultural loans and extending credit in areas having special flood hazards, as well as the requirements for issuing letters of credit and acceptances.

12 CFR 208.24 Letters of credit and acceptances. (a) Standby letters of credit. For the purpose of this section, standby letters of credit include every letter of credit (or similar arrangement however named or designated) that represents an obligation to the beneficiary on the part of the issuer: (1) To repay money borrowed by or advanced to or for the account of the account party; or (2) To make payment on account of any evidence of indebtedness undertaken by the account party; or (3) To make payment on account of any default by the party procuring the issuance of the letter of credit in the performance of an obligation. (c) Bank’s lending limits. Standby letters of credit and ineligible acceptances count toward member banks’ lending limits imposed by state law.
MEMORANDUM

TO: Hon. John M. Huff, Chair, Reinsurance (E) Task Force and Director of Insurance for the State of Missouri
    Stewart Guerin, Chair, Valuation of Securities (E) Task Force
    Members of the Reinsurance (E) Task Force and of the Valuation of Securities (E) Task Force

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

CC: Todd Sells, Director, NAIC Financial Regulatory Services
    Charles Therriault, Director, NAIC Securities Valuation Office

DATE: December 4, 2014

RE: Joint Project — Meaning and Intent of the Phrase “Securities Listed by the SVO” in Section 3 B. of the NAIC Credit for Reinsurance Model Law (#785) (Model Law) and Section 10 A. (2) of the Credit for Reinsurance Model Regulation (#786) (Model Regulation) — Proposed Amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (Purposes and Procedures Manual)

Executive Summary

Background — In the context of the captioned project, the SVO was asked to: 1) describe how the various sub-lists used to generate the compilation published as the Automated Valuation Service (AVS+) product are generated; 2) recommend measures to distinguish between “investments” and “bespoke securities”; 3) evaluate the risk that “bespoke securities” could be added to the AVS+ product; 4) discuss how NAIC staff may assist states to evaluate “bespoke securities”; and 5) make recommendations for appropriate changes to the Purposes and Procedures Manual.

Summary of Staff Report — The Purposes and Procedures Manual specifically directs insurers to file “investment securities” with the SVO unless they are filing exempt securities. The instruction to file securities with the SVO is in furtherance of an NAIC function performed by the SVO for all insurance departments. A security issued in connection with a transaction whose regulatory treatment derives from state processes that differ from NAIC processes for investment securities (such as the “bespoke” transaction discussed during the conference call that gave rise to this assignment) would not be an investment security in this sense. The SVO has long considered that a security issued as a funding solution to a company/state-specific regulatory issue is a regulatory transaction (Regulatory Transaction) eligible for filing as an investment security.

The risk that Regulatory Transactions could be added to the AVS+ products is greatest with respect to the Filing Exempt (FE) Data File; exists to some degree in the residential mortgage-backed securities (RMBS)/commercial mortgage-backed securities (CMBS) modeled population; and is very low for the U.S. Treasuries, Government Exemption and the Valuation of Securities (VOS) database generated and maintained by the SVO.

The SVO recommends that the term Regulatory Transaction be adopted and defined as discussed above for the Purposes and Procedures Manual and that the existing reference to investment securities be more formally defined to provide a contrast with Regulatory Transactions. This would make it clearer that an investment security is eligible for listing but that a Regulatory Transaction is not. The SVO also recommends that NAIC members consider the relationship between Regulatory...
Transactions and NAIC processes and identify parameters that should govern NAIC staff involvement in their assessment. The SVO recommends a proposed procedure for review that reflects current SVO practice.

In general, investments in subsidiary, affiliated and controlled (SCA) companies are subject to a different regulatory regime focused on market or equity-based valuation reflecting that SCA investments are inter-company transactions. SCA investments also are not investment securities in the sense of this paper. However, this implies no judgment on their suitability for use as collateral under the Model Law. Some specific debt and preferred stock in SCA companies, as exceptions, may qualify as investment securities.

At the present time, the Purposes and Procedures Manual does not describe the SVO compilation function. The SVO proposes text to describe the SVO compilation function as a first step in providing a definitional bridge between the compilation and the meaning of the phrase “Securities Listed by the SVO” in the Model Law.

An assessment of the mechanics of the compilation process shows that the quarterly compilation is derived from 12 sub-lists, only five of which are concerned with insurer owned investments securities and of which only three are published in the AVS+ product. To be specific, the SVO does not currently compile or publish a sub-list of Government Exempt securities in the quarterly compilation. The SVO recommends that the Government Exempt securities population be identified as a sub-list for purposes of the compilation and that it be published in the quarterly compilation. The SVO generates information about U.S. Treasuries from Schedule D filings, and this information is automatically added to the quarterly compilation. The SVO recommends that U.S. Treasury securities be identified as a sub-list of the compilation.

The SVO quarterly compilation may contain populations of securities that may be unsuitable for use as collateral in reinsurance transactions. In addition, the SVO quarterly compilation contains lists that contain information, some of which pertain to securities but most of which do not. Lists of information pertaining to securities may be suitable for Model Law purposes.

Just as importantly, the SVO quarterly compilation is unlikely to contain all of the populations of securities that would be desirable for Model Law purposes. To address this issue, the SVO proposes a definitional mechanism for the use of the Reinsurance (E) Task Force that would permit the identification of populations of securities deemed eligible for use as collateral in reinsurance transactions beyond the population of insurer owned securities the SVO compiles and publishes. The proposed mechanism is illustrated in the proposed amendments in Attachment One but would require input from the Reinsurance (E) Task Force before it could be customized and implemented.

Recommendation – The phrase “Securities Listed by the SVO” in the Model Law can be defined easily in the Purposes and Procedures Manual. Once the SVO compilation function has been fully described, those sub-lists of securities used in the compilation that are deemed to be appropriate for use as reinsurance collateral could be identified in the proposed definitional bridge as Securities Listed by the SVO for purposes of the Model Law.

Discussion and Analysis

1. Introduction – On Oct. 29, 2014, the Reinsurance (E) Task Force and members of the Valuation of Securities (E) Task Force (“VOSTF”) discussed comments received in response to the release of an Exposure Draft prepared by NAIC staff on the captioned project. The captioned project began with an SVO research paper that identified populations of securities that should be considered to be within the meaning of the phrase “Securities Listed by the SVO.” The Exposure Draft recommended that the Reinsurance (E) Task Force and the VOSTF consider whether other SVO activities should also be deemed to be within the phrase. One of the comment letters discussed on the Oct. 29 conference call1 said it was necessary to exclude “bespoke”

1 See the comment letter submitted by New York Life, dated Sept. 5, 2014, signed by George Nichols III and Joel M. Steinberg.
securities from the definition of “Securities Listed by the SVO.” In the ensuing discussion, the SVO noted that only investment securities were eligible for filing with the SVO and that the history of the filing exempt rule indicated that filing exempt securities must also be investment securities. The SVO also stated that the bespoke transaction discussed during the conference call illustrated what the SVO called a regulatory transaction: i.e., a security issued as part of a transaction whose objective is to resolve a company/state-specific regulatory issue and governed by state processes different from NAIC processes for investment securities (Regulatory Transaction). Regulatory Transactions can be assessed by the SVO for the benefit of the NAIC member but are not eligible for inclusion in the NAIC database used to hold information about investment securities prior to the compilation and publication of that information. At the conclusion of the call, the SVO was asked to: 1) recommend measures to distinguish between “investment” and “regulatory” securities; 2) describe the compilation process, including how the various sub-lists are compiled; 3) evaluate the risk of regulatory transactions being added to the AVS + product; and 4) discuss how NAIC staff may assist states to evaluate regulatory transactions and make proposals for appropriate changes to the Purposes and Procedures Manual.

2. Investment and “Regulatory” Securities

a. Investment Securities – The Purposes and Procedures Manual provides that any insurance company required under applicable state law to report NAIC Designations and Unit Prices for their “investments” in the NAIC Financial Statement Blank report the purchase of investment securities and other relevant transactions to the SVO. This is consistent with the purpose of SVO credit assessment processes, which are concerned with the likelihood that an issuer/obligor will be able to pay interest and principal on the obligation to the insurer in accordance with the terms of the agreement. Both the SVO assessment of insurer owned investments and the instruction that its determinations be entered into the AVS+ product are exclusively associated with NAIC processes identified in the definition of NAIC Financial Condition Framework and expressed in other NAIC guidance. Accordingly, SVO analytical determinations produced for an individual state intended to be used by that state outside of the NAIC Financial Condition Framework are not entered into NAIC systems. If determinations pertaining to Regulatory Transactions were entered into NAIC systems, it would convey that the security could be purchased by any insurer when in fact the insurer would first have to seek approval of its state regulator before it could use the solution the transaction was developed to provide.

b. Investments Securities, SCA Investments and Regulatory Transactions

1. SCA Common Stock – Investments that meet the definition of SCA investments are reported on the basis of a valuation derived from specified market or equity valuations and, therefore, not regulated on the basis of credit quality. SVO valuations for SCA investments are stored in a distinct segment of the VOS database and are not published in the quarterly compilation.

---

2 The concern is that securities on the AVS + product would be an admitted asset for a life insurer and a “primary security” under the NAIC Principle Based Reserving Framework (Framework). Such securities are eligible reinsurance collateral to support a XXX or AXXX reserve financing. A bespoke transaction—characterized as a transaction structure that collateralizes a portion of “redundant” reserve with a contingent note or other instrument linked to the modeling of the life insurer’s reserves—is conditional and, hence, inconsistent with the expectation that a primary security unconditionally back the life insurer’s general account liabilities.

3 See Part Two, Section 2 (a). The filing instruction is narrowed through the exemptions from filing with the SVO collected in Part Two, Section 4.

4 A comprehensive statement of SVO responsibilities and analytical products is set forth in Part One, Section 2 (a) and (b).

5 Part One, Section 3 (f)

6 Part Two, Section 1

7 Part Two, Section 1

8 Part Two, Section 1

9 Part Two, Section 1

10 Part Two, Section 2 (d) A long standing NAIC policy provides that an investment security must only be reported to the SVO once by any insurer. Other insurers who own the same security are instructed not to file with the SVO if it is shown in NAIC systems with current NAIC Designation and Unit Prices. By extension, any insurer that owns a security in NAIC systems is free to report the NAIC Designation Category and other analytical values assigned to the state insurance regulator.

11 See Part One, Section 3 (b) (v) (B) of the Purposes and Procedures Manual.
2. **Affiliated Debt and Preferred** – It is possible that a debt or preferred stock issued by an insurer and purchased by an affiliate of that issuer would qualify as an investment security. That determination is made on the basis of a methodology that requires the assessment of **Statement of Statutory Accounting Principles (SSAP) No. 97—Investments in Subsidiary, Controlled, and Affiliated Entities** arms-length and economic transaction criteria in addition to typical credit assessment methodologies for the security. With the exception of affiliated SCA debt or preferred stock obligations, the **Purposes and Procedures Manual** concern is with investments between **unaffiliated** entities. To help identify affiliated transactions, during the filing process insurers are required to identify whether the security is the subject of discussion with state insurance regulators and whether the security is part of a transaction involving affiliates. The insurer filing such a transaction is advised that the transaction is ineligible for filing with the SVO.

e. **Regulatory Transactions** – Regulatory Transactions are presented to the SVO because the **Purposes and Procedures Manual** provides that state insurance regulators may request SVO and Structured Securities Group (SSG) assistance on any investment matter specific to their department. By definition, such assignments are special regulatory assignments and may involve state law and state regulatory processes outside of the NAIC Financial Conditions Framework for investment securities. Most of such regulatory transactions do not require the production of an NAIC Designation or other analytical value, but when they do, these are given to the state insurance department for their exclusive use and are not entered into NAIC systems connected to the compilation process.

3. **Describe How the Sub-Lists Are Compiled**

a. **12 Sub-Lists** – The compilation is produced from 12 sub-lists, identified below. (Please also see Attachment Two.)

- VOS database
- FE Data File
- Government Exemptions
- RMBS/CMBS Modeled Securities
- Money Market Funds
- Letter of Credit Banks
- Derivative Counterparties
- Surplus Notes (NAIC 1)
- Surplus Notes (NAIC 2 – NAIC 6)
- Exchange Rates
- Ex-Dividend
- SCA

b. **List of Securities** – Of the 12 sub-lists, ONLY five are concerned with insurer owned investment securities:

- VOS database
- FE Data File
- Government Exemptions;
- RMBS/CMBS Modeled Securities
- SCA investments

c. But of these five, ONLY three are sub-lists of insurer owned securities published in the AVS+ product:

- VOS database

---

12 Part Three, Section 2 (d) (i) (B) (1)
13 Part Two, Section 2 (b)

© 2015 National Association of Insurance Commissioners 4
(Rev 01/13)
- FE Data File
- RMBS/CMBS Modeled Securities

The information from two of these lists is NOT published in the AVS+ product:

- Government Exemptions
- SCA.

d. The SVO recommends that two additional sources of insurer owned securities be recognized as sub-lists of securities to be published quarterly in the AVS+ product:

- Government Exemption (currently produced but not published in the VOS Products)
- U.S. Treasuries (currently automatically added to the VOS database, but not formally a sub-list)

Under this approach, the quarterly compilation and the Securities Listed by the SVO would be insurer owned securities on the following sub-lists:

- VOS database
- FE Data File
- RMBS/CMBS Modeled Securities
- Government Exemption
- U.S. Treasuries

The remaining seven lists communicate information to insurers and state insurance regulators but are not lists of securities:

- Money Market Funds and Exchange Traded Funds14
- Letter of Credit – Bank List
- Derivative Counterparties
- Surplus Notes (NAIC 1)
- Surplus Notes (NAIC 2 – NAIC 6)
- Exchange Rates
- Ex-Dividend

These sub-lists of Other Information would be identified as part of the SVO quarterly compilation.

The proposed distinction between lists of securities and lists of other information reflects the needs of the Valuation of Securities (E) Task Force for a quarterly compilation of insurer owned investment securities and other information. Accordingly, SCA investments would not be included because they are not investment securities for purposes of the VOSTF. This perspective is reflected in the proposed amendment to the Purposes and Procedures Manual. However, the distinction between lists of securities and lists of other information would also provide a starting place for the Reinsurance (E) Task Force. The Reinsurance (E) Task Force would use these defined terms to pick the sub-lists (whether of insurer owned securities or other information (i.e., the money market and exchange traded funds [ETF] fund lists) in the compilation process that are eligible for use as collateral in reinsurance transactions. The proposed definitional bridge could then be adjusted to

14 It is possible to argue that the Money Market Fund and ETF Lists are, in fact, lists of securities. The characterization of the list as a list of information simply reflects that the purpose of the list, from the operational perspective of the Valuation of Securities (E) Task Force, is to identify bond-like funds—not to compile insurer owned securities. Money market funds and ETFs that insurers purchase are reported as bonds in the list compiled by the SVO from the VOS Database. There is clearly no reason why the Reinsurance (E) Task Force could not determine that it wishes to permit insurers to use such funds as collateral in reinsurance arrangements.
identify other populations of securities not part of any list used in the compilation that is eligible for use as collateral in reinsurance transactions.

4. Risk of Regulatory Transaction Making the List – The SVO was asked to opine on the likelihood that a Regulatory Transaction could be added to the SVO quarterly compilation of investment securities. Characterization of a transaction as a Regulatory Transaction can only be made after an assessment of its structure, whether its purpose is making an investment and whether it contains a promise to repay a debt obligation. The SVO, therefore, does not think it is possible to exclude such transactions through the use of electronic system processes. Viewed as a compliance issue, we believe it is unlikely a Regulatory Transaction could be added to the VOS database because the SVO analyst must assess the transaction documents and structure. We also think it is unlikely that a Regulatory Transaction could be included into the Government Exempt or U.S. Treasuries processes because these activities involve U.S. government or government-sponsored enterprise (GSE) issuers. While most RMBS/CMBS securities are subject to financial modeling, those that cannot be modeled but have credit rating provider (CRP) credit ratings can be reported using those ratings. Any RMBS/CMBS rated by a CRP that was part of a Regulatory Transaction could be filed that way, although this would seem to involve a willful noncompliance that staff would not easily attribute to any insurer. Newly purchased RMBS/CMBS transactions filed with the SSG for an Initial Information Sufficiency assessment would be subject to detailed assessment that would identify whether it is part of a Regulatory Transaction. Those in the legacy population were never subject to review by the SVO or the SSG and could not be subjected to a structural review at this time. The FE Data File is generated electronically without input by SVO or SSG personnel at any time and is potentially subject to the same risk identified for RMBS/CMBS that are regulated on the basis of CRP credit ratings. The SVO recommends that text be added to each section that identifies a sub-list process to make clear that Regulatory Transactions are not eligible for compilation as a part of the sub-list.

5. Discuss How NAIC Staff May Assist States to Evaluate Regulatory Transactions – Part Two Section 2 (b) of the Purposes and Procedures Manual authorizes state regulators to request and the SVO to provide assistance with respect to the analysis of a FE security or with respect to any investment issue before the department. This section is often used to request SVO and/or SSG assistance in the analysis of inter-affiliated transactions and in the assessment of transactions designed to resolve a regulatory issue that the state insurance department has been asked to approve. Some of these transactions are submitted under Regulatory Treatment Analysis Service (RTAS), and some are submitted by the insurer per instructions of the state insurance department. Although Section 2 (b) authorizes the request and grant of analytical assistance, it does not anticipate, we believe correctly, that there would be a relationship between the state determination for the inter-affiliated and regulatory transaction and NAIC processes. Based on the analysis shown above, the SVO has taken the position that it is not authorized to insert inter-affiliated and regulatory transactions into NAIC systems intended to hold information about investment securities. State insurance departments do not usually object to this, but some states have asked whether they are authorized to instruct the company to show the NAIC Designation and accounting determination provided by SVO and NAIC staff in their financial reporting to that or those state(s). In response to such requests, the SVO and other NAIC staff have indicated that it is appropriate for the state to do so provided that it is clear the adoption of the staff guidance on those issues is pursuant to a state determination distinct from the NAIC Financial Conditions Framework. We see no harm, and much benefit accruing to the members of the NAIC if they can leverage staff resources to resolve complex analytical issues, provided the members also distinguish between an NAIC agreed upon position and a unique state determination based entirely or predominantly on a state’s non-NAIC-related law or regulatory framework. The SVO believes more formal guidelines on this issue would help formalize staff practices and also provide guidance to states that are trying to resolve complex investment and related analytical issues. Although the suggested guidelines are concerned with SVO and SSG activity, it is clearly desirable for this guidance to be comprehensive and that it include guidance related to statutory accounting and reporting issues.

6. Summary of Proposed Amendments – The mechanism the SVO proposes for the use of the Reinsurance (E) Task Force would first require the following amendments to the Purposes and Procedures Manual:

© 2015 National Association of Insurance Commissioners

(Rev 01/13)
Part One, Section 2 – Describe the SVO compilation function as an ongoing SVO operation. Specify that to fulfill its function, the SVO must also be able to convey to an insurer that a filing is not eligible for filing with the SVO as an Investment Security reported on Schedule D, for example, because it is an Other Invested Asset or, in the context we are discussing, because it is a Regulatory Transaction.

Part Two, Section 1 – Identify and define all sub-lists or sources used to store securities or other information to compile and publish the quarterly compilation in the AVS+ product.

Part One, Section 3 (e) – Modify the FE Securities Data File section to clarify it only contains Investment Securities and to explain how it is created. Add new sections for the RMBS/CMBS Modeled Securities Process, the U.S. Treasury Securities Process and the Exempt U.S. Government Securities Process to provide the same disclosure and explanation for each of these sub-lists.

Use the names assigned to each sub-list in the compilation process to create a Reinsurance (E) Task Force-specific definition of Securities Listed by the SVO for purposes of the Model Law.

Part Two, Section 2 (a) – Amend the core instruction to insurers that they file investments with the SVO to refer to Investment Securities, define that term and prohibit the SVO from assessing a Regulatory Transaction under this section.

Part Three Section 2 (d) – Amend the SCA methodology concerned with SCA Debt and preferred stock to clarify the methodology is used to permit the SVO to determine whether an SCA Debt or SCA preferred stock is eligible for reporting as an Investment Security.

Part Three, Section 2 a – Add guidelines for NAIC staff assistance to states in the assessment of Regulatory Transactions.
Attachment One

Proposed Amendments to the *Purposes and Procedures Manual*

**Part One – Purposes, General Procedures and Instructions to the SVO**

Section 2. Policies Defining the SVO Staff Function

(a) Directive to Conduct Ongoing SVO Operations

The SVO shall conduct the following ongoing operations:

(i) Analysis of credit risk for purposes of assigning an NAIC Designation.

(ii) Valuation analysis to determine a Unit Price.

(iii) Identification and analysis of securities that contain other non-payment risk and communication of this information by assignment of the NAIC Designation subscript to such securities.

(iv) Other analytical assignments requested by the VOS/TF or members of the regulatory community in accordance with the directives, procedures and general methodologies described in this Manual.

(v) Compile and publish the VOS PAVS+ products in accordance with instructions in this Manual.

(b) SVO Regulatory Products

(i) NAIC Designations

(ii) Valuation of Securities

(iii) Other Non-Payment Risk in Securities

(iv) Authority to Direct Insurers on Reporting

The SVO only has responsibility and authority for assessment of securities that are reportable on Schedule D and Schedule BA of the Annual Statement Blank. It is, therefore, part of the role of the SVO to determine when financial instruments or securities are not eligible for reporting on Schedule D and Schedule BA. The SVO may, therefore, be required to inform an insurer to redirect a financial instrument or security reported to the SVO to another schedule. Similarly, the SVO may also be required to inform an insurer that an instrument filed with the SVO pursuant to Part Two, Section 2 (a) of this Manual does not meet the definition of an Investment Security and cannot be assessed as such or that a financial transaction or security filed with the SVO meets the definition of a Regulatory Transaction eligible for assessment by the SVO under Part Three, Section 3 (c) of this Manual. In all cases in which a situation described in this subparagraph is presented, final determination as to what, but only after consulting the NAIC Accounting Practices and Procedures Manual statutory accounting and reporting applies to the instrument or security is made in consultation between NAIC statutory accounting staff and the SVO.

Section 3. Internal Administration

(d) SVO Departments

The SVO shall establish such procedures or guidelines as are necessary to delineate analytical and administrative responsibility for specific securities among departmental groups. The SVO also shall establish procedures for...
sharing administrative and analytical oversight for securities deemed to require application of methodologies from more than one department.

**Valuation of Securities Process**

Upon determination of either component of an Association Value, (i.e., the NAIC Designation or Unit Price), and of a classification, as the case may be, for an Investment Security, as defined in Part Two, Section 2 (a) of this Manual, the SVO shall enter such NAIC Designation, Unit Price and classification in the NAIC's VOS Process.

The SVO shall not add a Regulatory Transaction, as defined in Part Three Section 3 (d) of this Manual, to the VOS Process.

**Filing Exempt Securities Process**

A filing exempt (FE) security is an Investment Security, as defined in Part Two, Section 2 (a) of this Manual, that is exempt from filing with the SVO, as otherwise required by Part Two, Section 2 (a) of this Manual, pursuant to the filing exemption in Part Two, Section 4 (d) of this Manual. Insurance companies derive NAIC Designations for filing exempt FE securities by applying the conversion instructions in Part Two Section 4(d) (i) (A) and (B) of this Manual and the equivalency relationships disclosed in Section 7(d) (ii) of this Part.

NAIC Designations assigned to filing exempt FE securities are reported by the insurance company to the NAIC and subsequently added by NAIC staff to the FE Data File.

Insurance companies shall not report Regulatory Transactions, defined in Part Three Section 3 (d) of this Manual, as filing exempt FE securities, and the NAIC staff shall not add a Regulatory Transaction to the FE Data File.

**RMBS/CMBS Modeled Securities Process**

An residential mortgage-backed securities (RMBS) or a commercial mortgage-backed securities (CMBS) security are an Investment Security, as defined in Part Two, Section 2 (a) of this Manual. An RMBS or CMBS that is subject to financial modeling by the SSG and an RMBS or CMBS that is not subject to financial modeling by the SSG, but has been assigned credit ratings by one or more NAIC CRPs, are filed with the SVO. An RMBS or a CMBS that is not capable of being financially modeled and is also not rated by an NAIC CRP, is subject to filing with the SVO and will be added to the VOS Process by the SVO.

RMBS and CMBS are reported by the insurance company to the NAIC and subsequently added by NAIC staff to the RMBS/CMBS Modeled Securities Process, where on an annual basis and for purposes of the annual surveillance discussed in Part Seven, Section 5 (a) of this Manual, they are evaluated for eligibility to be financially modeled. RMBS and CMBS that are deemed to be subject to financial modeling are retained in the RMBS/CMBS Modeled Process. RMBS and CMBS that are deemed ineligible for financial modeling but that have been assigned credit ratings by NAIC credit rating providers (CRPs) migrate to the FE Date File. RMBS and CMBS that are deemed ineligible for financial modeling and that have also not been assigned credit ratings by NAIC CRPs are filed with the SVO and accordingly migrate to the VOS Process.

Insurance companies shall not report Regulatory Transactions, defined in Part Three Section 3 (d) of this Manual, as eligible for the RMBS/CMBS Modeled Securities Process, and the NAIC staff shall not add a Regulatory Transaction to the RMBS/CMBS Modeled Securities Process.

**U.S. Treasury Securities Process**

© 2015 National Association of Insurance Commissioners  
(Rev 01/13)
U.S. Treasury Securities are an Investment Security, as defined in Part Two, Section 2 (a) of this Manual, that is exempt from filing with the SVO, as otherwise required by Part Two, Section 2 (a) of this Manual, pursuant to the filing exemption in Part Two, Section 10 (c) (v) of this Manual.

U.S. Treasury Securities are added to the U.S. Treasury Securities Process automatically by electronic processes administered by the SVO and are assigned an NAIC Designation by a policy-based convention.

Insurance companies shall not report Regulatory Transactions, defined in Part Three Section 3 (d) of this Manual, as U.S. Treasury Securities, and the NAIC staff shall not add a Regulatory Transaction to the U.S. Treasury Securities Process.

**Exempt U.S. Government Securities Process**

An exempt U.S. Government Security is an Investment Security, as defined in Part Two, Section 2 (a) of this Manual, that is exempt from filing with the SVO, as otherwise required by Part Two, Section 2 (a) of this Manual, pursuant to the filing exemption in Part Two, Section 4 (c) of this Manual.

An exempt U.S. Government security is reported by the insurance company to the NAIC and subsequently added by NAIC staff to the Exempt U.S. Government Securities Process and by policy convention are assigned NAIC Designation pursuant to a policy-based convention.

Insurance companies shall not report Regulatory Transactions, defined in Part Three Section 3 (d) of this Manual, as exempt U.S. Government Securities, and the NAIC staff shall not add a Regulatory Transaction to the Exempt U.S. Government Securities Process.

**Filing Exempt Securities**

Filing exempt securities are defined in Part Two, Section 4 (d) of this Manual. The NAIC shall maintain computer system capabilities to include filing exempt securities in ISIS. The compilation will be performed in accordance with the eligibility rules set forth in this Manual as applied by the insurer holding the security or by the NAIC in comparing the security with the NAIC CRP rating feeds, except when regulatory policy set by the VOS/TF provides a different regulatory treatment for a filing exempt security than would otherwise apply based on the NAIC CRP assigned credit rating.

NAIC Designations assigned to filing exempt securities shall be derived by application of the conversion instructions in Part Two Section 4(d) (1) (A) and (B) of this Manual and the equivalency relationships disclosed in Section 3(d) (ii) of this Part except when regulatory policy set by the VOS/TF under Section 2 (f) of this Part or otherwise provides a different regulatory treatment for a filing exempt security than would otherwise apply based on the NAIC CRP assigned credit rating. ISIS shall show the name of the security, including a security identification number, the NAIC Designation and classification assigned to it and the Unit Price, if available.

**Valuation of Securities Process**

Upon determination of either component of an Association Value, i.e., the NAIC Designation or Unit Price, and of a classification, as the case may be, the SVO shall enter such NAIC Designation, Unit Price and classification in the NAIC VOS Process. For securities eligible for the filing exemption contained in Part Two, Section 4 (d) of this Manual, NAIC Designations shall be assigned and entered into the VOS Process in accordance with the instructions contained in Section 3 (c) of this Part above.

**Compilation and Publication of the SVO List of Securities Valuation of Securities Products**

On a quarterly basis, the SVO shall:

2) Aggregate the content of each SVO Sub-List into a single SVO List of Investment Securities (hereafter, the SVO List of Securities) identifying each Investment Security by name and other pertinent information and showing the NAIC Designation and/or Unit Price assigned to them by the SVO or pursuant to the methodology otherwise specified in this Manual.

3) Compile, or cause to be compiled, sub-lists from the informational content of the Derivative Counterparties Process, Exchange Rates Process, Ex-Dividend Process, Letter of Credit Process, Money Market and Exchange Traded Fund Process and Surplus Notes Processes (each an SVO Sub-List bearing the name of the corresponding Process and collectively the “Other Information”), and

4) Publish, or cause the SVO List of Securities and the Other Information to be published, by being incorporated into the NAIC’s AVS+ products.

(1) Reference to SVO List of Securities

The NAIC, acting by and through its Valuation and of Securities (E) Task Force and its Reinsurance (E) Task Force, acknowledges that the phrase "Securities Listed by the SVO," used in Section 3 B. of the NAIC Credit for Reinsurance Model Law (#785) and Section 10 A. (2) of the Credit for Reinsurance Model Regulation (#786) refers to the SVO List of Securities as defined in this Part One, Section 3 (k) provided that for purposes of the Model Law, the phrase Securities Listed by the SVO also includes: [Please Note, the following text is inserted for purposes of illustration only]

1) The money market funds on the Money Market Funds Sub-List and the exchange traded funds on the ETF Sub-List,

2) Any Letter of Credit identified in the Letter of Credit Sub-List,

3) All U.S. Treasury Securities whether or not actually owned by an insurance company; and

3) ...

To avoid confusion, and for purposes of this acknowledgment, the Filing Exempt Process included in the definition of SVO List of Securities includes the SVO listed securities referred to as those "deemed exempt from filing" in the cited sections of the Model Law and Model Regulation.

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.

... Derivative Counterparties Process means a file in NAIC electronic systems used to store the names of counterparties that have been applied to be added to the List of Counterparties for Schedule DB – Part D – Section 1 for purposes of netting of derivative exposures that is used in connection with the publication of the VOS+ AVS+ Products. ...
Exchange Rates Process means a file in NAIC electronic systems used to store currency exchange rates used by insurance companies to convert the value of foreign investments into U.S. Dollars for reporting purposes and used in connection with the publication of the AVS+ pVOS Products.

Exempt U.S. Government Securities Process refers to a Process within NAIC electronic computer systems used to store the names and descriptions of U.S. Government Securities that are exempt from filing with the SVO and that is used in connection with the publication of the AVS+ pVOS Products.

Ex-Dividend Process means a file created in NAIC electronic systems used to store information about stock dividends and that is used in connection with the publication of the AVS+ pVOS Products.

---

Filing Exempt DataFile refers means the Filing Exempt Datafile and refers to an electronic file within on the NAIC electronic computer system that is used to store the names and descriptions of securities owned by state-regulated insurance companies that are exempt from filing with the SVO because they are assigned credit ratings by NAIC CRPs and data items of FE securities that insurers: (1) have reported in quarterly or annual statements (NAIC Financial Statement Blank) filed with the NAIC; or (2) requested to be included in the Filing Exempt DataFile through the Integrated Securities Information System (ISIS) and in both cases, for which an NAIC CRP rating has been confirmed by the NAIC—and that is used in connection with the publication of the AVS+ pVOS Products.

---

Letter of Credit Process means a file in NAIC electronic systems used to store the names of banks that issue letters of credit in support of credit for reinsurance arrangements and that meet eligibility criteria to be placed on the NAIC Bank List that is used in connection with the publication of the AVS+ pVOS Products.

---

Money Market and Exchange Traded Fund Process refers to the component of NAIC systems used to store the names of Money Market Funds and Exchange Traded Funds eligible for reporting as bonds used in connection with the publication of the AVS+ pVOS Products.

---

RMBS/CMBS Modeled Securities Process refers to a Process within NAIC electronic computer systems used to store the names and descriptions of residential mortgage-backed securities and commercial mortgage-backed securities that have been financially modeled by the Structured Securities Group (SSG) and that is used in connection with the publication of the AVS+ pVOS Products.

---

Surplus Notes (NAIC1) Process refers to the component of NAIC systems used to store the names of Surplus Notes rated by CRPs at the NAIC equivalent used in connection with the publication of the AVS+ pVOS Products.

Surplus Notes (NAIC 2 – NAIC 6) Process refers to the component of NAIC systems used to store the names of Surplus Notes rated by CRPs at the NAIC equivalent used in connection with the publication of the AVS+ pVOS Products.

---

© 2015 National Association of Insurance Commissioners

(Rev 01/13)
U.S. Treasury Securities Process refers to a process within NAIC electronic computer systems used to store the names and descriptions of U.S. Treasury Securities and that is used in connection with the publication of the AVS+ pVOS Products.

VOS Process Process means the Valuation of Securities Process and refers to a process within NAIC electronic computer systems 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, and together with the NAIC Designation categories and/or Unit Price assigned to them by the SVO and that is used in connection with the publication of the AVS+ pVOS Products.

AVS+ pVOS Products refers to the quarterly compilation of the SVO List of Securities information derived from the VOS Database, the FE Datafile, Unit Prices assigned by the SVO and Unconfirmed FE’s and the Other Information as those terms are defined in Part Two, Section 3 (j) of this Manual.

Section 2. General Reporting Framework

(a) Obligation to Report

Insurance companies domiciled in any state of the United States, or any of its territories or possessions, and required by the law of their domiciliary state or territory to report NAIC Association Values for their Investment Securities in the NAIC Financial Statement Blank, shall report purchases of Investment Securities or any other relevant transaction to the SVO or, in the case of Investment Securities exempt from filing with the SVO, for example, pursuant to Section 4 (d) of this Part below, to the NAIC as required by this Manual.

For purposes of this Part Two, Section 2 (a), an Investment Security means an instrument evidencing a lending transaction between an insurance company as lender and a non-affiliated borrower, where the borrower’s sole motivation is to borrow money and the insurance company’s sole motivation is to make a profit on the loan that the state of domicile regulates by reference to the NAIC Financial Conditions Framework.

The SVO shall have no authority to issue NAIC Designations or any other NAIC analytical product to an insurance company for a Regulatory Transaction under this Section 2 (a).

See Part Three, Section 3 (d) below for the definition of Regulatory Transaction and a description of the processes governing their assessment.

(b) Authority to Require a Filing with the SVO

The existence of a filing exemption for a transaction, security, financial asset or investment activity in any Part of this Manual is not intended to, and shall not be read as, prohibiting a state insurance regulator from requiring its domiciled insurance company to file a transaction, security, financial asset or investment activity with the SVO for analysis.

In addition, nothing in this Manual should be read as prohibiting a state insurance regulator from asking for SVO or SSG analytical assistance with respect to any investment related activity, or in connection with assessment of investment-related aspects of a Regulatory Transaction, as defined in Part Three, Section 3 (c) of this Manual and directing an insurance company to file relevant information with the SVO or the SSG for that purpose.

Part Three – Credit Assessment
Section 2. Corporate Bonds and Preferred Stock – Special Assessment Situations

Bonds and preferred stock that fit the description set out below shall be subject to the general procedures specified above as well as the specific or special procedures identified below.

(d) SCA Debt and Preferred Stock

Part Five, Section 2 of this Manual governs valuation of Subsidiary, Controlled and Affiliated (SCA) investments in the form of common stock and in the form of preferred stock issued by an insurance company. This section applies to credit assessment of any SCA investment in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity (‘SCA debt’) and preferred stock issued by a non-insurer entity (‘SCA preferred stock’). This procedure is used to determine whether an SCA debt or SCA preferred transaction is eligible for reporting as an Investment Security pursuant to Part Two Section 2 (a) of this Manual.

(e) Regulatory Transactions

i. Defined – Regulatory Transaction means a security or other instrument in a transaction designed as to solve an insurance company regulatory issue submitted to one or more state insurance departments for review and approval under the regulatory framework of the state or states.

ii. Intent – This Section provides guidance to the SVO and the SSG on how to manage requests for assistance made by a state insurance department under Part Two, Section 2 (b) of this Manual.

iii. Guidelines

The SVO or SSG is authorized to conduct an analytical assessment on behalf of any state insurance department that requests such assistance.

If an insurance company files a Regulatory Transaction with the SVO via the ATF process or under the Regulatory Treatment Analysis Service (RTAS) process, the SVO shall first contact the state insurance department of the insurance company’s state of domicile to disclose that a Regulatory Transaction has been submitted and inquire whether the state insurance department wants SVO analytical assistance.

If the state insurance department of the insurer’s state of domicile request such assistance, the SVO shall engage in the requested analytical assessments of the Regulatory Transaction. SVO determinations may include and refer to NAIC analytical benchmarks, such as NAIC Designations, valuation or classification assessments, and such determinations may be given by the SVO or SSG to the state insurance department.

SVO or SSG determinations given in connection with the assessment of a Regulatory Transaction may be given to and adopted by the state insurance department as part of that state’s internal determination of the regulatory issues presented by the Regulatory Transaction. However, SVO assessments for a Regulatory Transaction will not be entered into NAIC computer systems reserved for Investment Securities, as defined in Part Two, Section 2 (a) or added to the SVO List of Securities as defined in Part One, Section 3 (g).
Attachment Two
Identification of the Sub-Lists that Constitute the Quarterly Compilation of Insurer-Owed Investments Compiled and Published under Part One, Section 3 (g) of the Purposes and Procedures Manual

List of Insurer Owned Securities Compiled Quarterly and Published in AVS+

Valuation of Securities (VOS) Process – The Integrated Securities Information System (ISIS) contains a customized sub-system (also called VOS) allowing SVO credit analysts to review and assign NAIC Designation to certain Schedule D and Schedule BA issues owned by insurance companies. This environment mandates check-and-balance credit assessment measures among SVO analysts and managers, including formal sign-offs, data entry controls, etc. The VOS Process is accessible within the Automation Valuation Service (AVS+) product.

Filing Exempt (FE) Data File – An automated process is run daily whereby unique CUSIP numbers are identified from the NAIC Schedule D Annual and Quarterly Statements and cross-referenced against the CUSIP data feed. This resulting population is then compared to rating feeds from our eight credit rating providers (CRPs) whereby the second lowest rating from the rating vendors culminates into an NAIC FE Designation. The contents of the FE data file are electronically generated and cannot be manipulated by SVO personnel at any time. The FE Process is also accessible within AVS+.

RMBS/CMBS Modeled Securities – This population of residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) securities are supported by the Structured Securities Group (SSG), which collaborates with third-party vendors (currently PIMCO for RMBS and Blackrock Solutions for CMBS) to determine critical data points to provide guidance to insurers on how to determine NAIC Designations and report them with the NAIC. The SVO credit staff are not directly involved in this process. The RMBS/CMBS population is accessible within AVS+.

NOTE: U.S. Treasuries are included in the quarterly compilation and published in AVS+, but it is not identified as a separate list by the compilation function because it is compiled through a process not involving filings by insurers.

List of Insurer Owned Securities Compiled Quarterly but NOT Published in AVS+

Government Exemptions – Certain U.S. Government Agency issues—including Fannie Mae, Freddie Mac, Ginnie Mae, etc.—are exempt from filing with the SVO as well as excluded from the automated FE daily process. This population is determined through insurer reporting with the NAIC and is not manipulated at any time by SVO personnel. This population is not available within AVS+.

NOTE: The staff recommend that the Government Exemptions be considered a list of securities and that it be added to AVS+. The staff also recommend that the list be identified as a list of securities eligible for use in reinsurance transactions.

Subsidiary, Controlled and Affiliated (SCA) – SCA companies are filed by insurers with the SVO and captured as an independent Process within the ISIS system. This Process is accessible for regulators within I-SITE but not for AVS+ subscribers.

NOTE: SCA investments are valued on either market or an equity basis and are not assessed for credit quality by the SVO or CRPs. The staff recommend that the Reinsurance (E) Task Force consider whether a sub-list of SCA investments should be identified as a list of securities eligible for use in reinsurance transactions.

List Containing Information – Compiled Quarterly and Published in AVS+

© 2015 National Association of Insurance Commissioners

(Rev 01/13)
Money Market Funds – Issuers of money market funds that meet certain criteria for exemption from NAIC reserve requirements submit approval applications to the SVO. The SVO staff verify the funds meet the criteria and ensure they are included in the NAIC Approved Money Market Fund Listing. This list is sold as a monthly publication and posted quarterly within AVS+.

Letter of Credit Banks – Banks issuing letters of credit that meet certain criteria from the NAIC submit approval applications to the SVO. The SVO staff verifies the banks meet the criteria and ensure they are included in the NAIC Approved Bank List. This list is sold as a monthly publication and posted quarterly within AVS+.

Exchange Rates – A list of currency exchange rates is captured monthly by the SVO via Olsten & Associates (OANDA) www.oanda.com. These rates are used by insurance for converting foreign investments into US Dollars for reporting purposes. This listing is posted quarterly within AVS+.

Ex-Dividend – A listing of stock dividends issued by companies is retrieved directly from an outside vendor and posted quarterly within AVS+.

Derivative Counterparties – This listing consists of counterparties submitted by insurance companies to the SVO for approval provided specific NAIC criteria are met. This listing is posted quarterly within AVS+.

NOTE – In the opinion of the staff, with the possible exception of Money Market Fund (and Exchange-Traded Funds [ETF] lists), these lists are not relevant to the objectives of the Reinsurance (E) Task Force because they are lists of information, not lists of insurer owned securities. The Money (and ETF) lists differ in that they identify, respectively, money market, bond and exchange traded funds that are designated for credit quality and deemed eligible by the SVO for reporting on the bond schedule. Although the lists themselves are not lists of insurer owned securities, they are nevertheless lists of investments eligible for purchase by insurers. Accordingly, the staff recommend that the Reinsurance (E) Task Force consider whether these lists should be identified as a list of securities eligible for use in reinsurance transactions.

Surplus Notes (NAIC1) – This listing consists of surplus notes submitted by insurance companies to the SVO for verification that the Note is rated by a CRP and placed on a sub-list. This listing is posted quarterly within AVS+.

Surplus Notes (NAIC2–NAIC6) – This listing consists of surplus notes submitted by insurance companies with NAIC2–NAIC6 ratings or not rated at all. These securities are not assessed for credit quality. If filed, the SVO will calculate a statement factor for the insurance company used for Schedule BA reporting. This listing is posted quarterly within AVS+.

NOTE: The Investment Analysis Office does not have a view whether Surplus Notes should be identified as a list of securities eligible for use in reinsurance transactions. We would defer to the views of the Financial Regulatory Services (FRS) staff.
Proposed Amendments to the Purposes and Procedures Manual
UNMARKED VERSION – FOR DISCUSSION

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

Section 2. Policies Defining the SVO Staff Function

(a) Directive to Conduct Ongoing SVO Operations

The SVO shall conduct the following ongoing operations:
Analysis of credit risk for purposes of assigning an NAIC Designation.

Valuation analysis to determine a Unit Price.

Identification and analysis of securities that contain other non-payment risk and communication of this information by assignment of the NAIC Designation subscript to such securities.

(iv) Other analytical assignments requested by the VOS/TF or members of the regulatory community, in accordance with the directives, procedures and general methodologies described in this Manual.

Compile and publish the VOS Products in accordance with instructions in this Manual.

(b) SVO Regulatory Products

(i) NAIC Designations …

(ii) Valuation of Securities …

(iii) Other Non-Payment Risk in Securities …

(iv) Authority to Direct Insurers on Reporting

The SVO only has responsibility and authority to assess securities that are reportable on Schedule D and Schedule BA of the Annual Statement Blank. It is therefore part of the role of the SVO to determine when financial instruments or securities are not eligible for reporting on Schedule D and Schedule BA. The SVO may therefore be required to inform an insurer filer to redirect a financial instrument or security reported to the SVO to another schedule. Similarly, the SVO may also be required to inform an insurer filer that an instrument filed with the SVO pursuant to Part Two, Section 2 (a) of this Manual does not meet the definition of an Investment Security and cannot be assessed as such or that a financial transaction or security filed with the SVO meets the definition of a Regulatory Transaction eligible for assessment by the SVO under Part Three, Section 3 (e) of this Manual. In all cases in which a situation described in this subparagraph is presented, final determination as to what statutory accounting and reporting applies to the instrument or security is made in consultation between NAIC statutory accounting staff and the SVO.

Section 3. Internal Administration

(d) SVO Departments

The SVO shall establish such procedures or guidelines as are necessary to delineate analytical and administrative responsibility for specific securities among departmental groups. The SVO also shall establish procedures for sharing administrative and analytical oversight for securities deemed to require application of methodologies from more than one department.

© 2015 National Association of Insurance Commissioners 17

(Rev 01/13)
© 2015 National Association of Insurance Commissioners

18

(Rev 01/13)
Insurance companies shall not report Regulatory Transactions, defined in Part Three Section 3 (d) of this Manual, as US Treasury Securities and the NAIC staff shall not add a Regulatory Transaction to the US Treasury Securities Process.

(j) Exempt US Government Securities Process

An exempt US Government Security is an Investment Security, as defined in Part Two, Section 2 (a) of this Manual, that is exempt from filing with the SVO, as otherwise required by Part Two, Section 2 (a) of this Manual, pursuant to the filing exemption in Part Two, Section 4 (c) of this Manual.

An exempt US Government security is reported by the insurance company to the NAIC and subsequently added by NAIC staff to the Exempt US Government Securities Process and by policy convention are assigned NAIC 1 Designation.

Insurance companies shall not report Regulatory Transactions, defined in Part Three Section 3 (d) of this Manual, as exempt US Government Securities and the NAIC staff shall not add a Regulatory Transaction to the Exempt US Government Securities Process.

(k) Compilation and Publication of the SVO List of Securities

On a quarterly basis, the SVO shall:

1) Compile, or cause to be compiled, a list of Investment Securities from each of the VOS Process, FE Data Process, RMBS/CMBS Modeled Securities Process, US Treasury Process and the Exempt US Government Securities Process (each an SVO Sub-List bearing the name of the corresponding Process);

2) Aggregate the content of each SVO Sub-List into a single SVO List of Investment Securities (hereafter, the “SVO List of Securities”) identifying each Investment Security by name and other pertinent information and showing the NAIC Designation and/or Unit Price assigned to them by the SVO or pursuant to the methodology otherwise specified in this Manual;

3) Compile, or cause to be compiled, sub-lists from the informational content of the Derivative Counterparties Process, Exchange Rates Process, Ex-Dividend Process, Letter of Credit Process, Money Market and Exchange Traded Fund Process and Surplus Notes Processes (each an SVO Sub-List bearing the name of the corresponding Process and collectively the “Other Information”), and

4) Publish, or cause the SVO List of Securities and the Other Information to be published by being incorporated into the NAIC’s AVS + product.

(l) Reference to SVO List of Securities

The NAIC, acting by and through its Valuation and Securities (E) Task Force and its Reinsurance (E) Task Force acknowledges that the phrase “Securities listed by the SVO”, used in Section 3 B. of the NAIC Credit for Reinsurance Model Law (#785) and Section 10 A. (2) of the Credit for Reinsurance Model Regulation (#786) refers to the SVO List of Securities as defined in this Part One, Section 3 (k) provided that for purposes of the Model Law, the phrase Securities Listed by the SVO also includes: [Please Note, the following text is inserted for purposes of illustration only]

1) The money market funds on the Money Market Funds Sub-List and the exchange traded funds on the ETF Sub-List;

2) Any Letter of Credit identified in the Letter of Credit Sub-List;

3) All US Treasury Securities whether or not actually owned by an insurance company; and

© 2015 National Association of Insurance Commissioners

(Rev 01/13)
To avoid confusion, and for purposes of this acknowledgment, the Filing Exempt Process included in the definition of SVO List of Securities includes the SVO listed securities referred to as those “deemed exempt from filing” in the cited sections of the Model Law and Model Regulation.

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.

... 

**Derivative Counterparties Process** means a file in NAIC electronic systems used to store the names of counterparties on the List of Counterparties for Schedule DB – Part D – Section 1 for purposes of netting of derivative exposures that is used in connection with the publication of the VOS Products.

... 

**Exchange Rates Process** means a file in NAIC electronic systems used to store currency exchange rates used by insurance companies to convert the value of foreign investments into US Dollars for reporting purposes and used in connection with the publication of the VOS Products.

**Exempt US Government Securities Process** refers to a Process within NAIC electronic computer systems used to store the names and descriptions of US Government Securities that are exempt from filing with the SVO and that is used in connection with the publication of the VOS Products.

**Ex-Dividend Process** means a file created in NAIC electronic systems used to store information about stock dividends and that is used in connection with the publication of the VOS Products.

... 

**Filing Exempt Process File** refers to an electronic file within NAIC electronic computer systems used to store the names and descriptions of securities owned by state-regulated insurance companies that are exempt from filing with the SVO because they are assigned credit ratings by NAIC CRPs and that insurers: (1) have reported in quarterly or annual statements (NAIC Financial Statement Blank) filed with the NAIC or (2) requested to be included in the Filing Exempt Data File through the Integrated Securities Information System (ISIS) and in both cases, for which an NAIC CRP rating has been confirmed by the NAIC and that is used in connection with the publication of the VOS Products.

... 

**Letter of Credit Process** means a file in NAIC electronic systems used to store the names of banks that issue letters of credit in support of credit for reinsurance arrangements and that meet eligibility criteria to be placed on the NAIC Bank List that is used in connection with the publication of the VOS Products.

... 

**Money Market and Exchange Traded Fund Process** refers to the component of NAIC electronic systems used to store the names of Money Market Funds and Exchange Traded Funds eligible for reporting as bonds used in connection with the publication of the VOS Products.

...
RMBS/CMBS Modeled Securities Process refers to a Process within NAIC electronic computer systems used to store the names and descriptions of residential mortgage backed securities and commercial mortgage backed securities that have been financially modeled by the SSG and that is used in connection with the publication of the VOS Products.

---

Surplus Notes (NAIC 1) Process refers to the component of NAIC electronic systems used to store the names of Surplus Notes rated by CRPs at the NAIC equivalent used in connection with the publication of the VOS Products.

---

Surplus Notes (NAIC 2 – NAIC 6) Process refers to the component of NAIC electronic systems used to store the names of Surplus Notes rated by CRPs at the NAIC equivalent used in connection with the publication of the VOS Products.

---

US Treasury Securities Process refers to a Process within NAIC electronic computer systems used to store the names and descriptions of US Treasury Securities and that is used in connection with the publication of the VOS Products.

---

VOS Process means the Valuation of Securities Process and refers to a Process within NAIC electronic computer systems used to store the names and descriptions of securities owned by state-regulated insurance companies, and the NAIC Designation categories and/or Unit Price assigned to them by the SVO and that is used in connection with the publication of the VOS Products.

VOS Products refers to the quarterly compilation of the SVO List of Securities and the Other Information as those terms are defined in Part Two, Section 3 (j) of this Manual.

Section 2. General Reporting Framework

(a) Obligation to Report

Insurance companies domiciled in any state of the United States, or any of its territories or possessions, and required by the law of their domiciliary state or territory to report NAIC Association Values for their Investment Securities in the NAIC Financial Statement Blank shall report purchases of Investment Securities to the SVO or, in the case of Investment Securities exempt from filing with the SVO, for example, pursuant to Section 4 (d) of this Part below, to the NAIC, as required by this Manual.

For purposes of this Part Two, Section 2 (a) an Investment Security means an instrument evidencing a lending transaction between an insurance company as lender and a non-affiliated borrower; where the borrower’s sole motivation is to borrow money and the insurance company’s sole motivation is to make a profit on the loan that the state of domicile regulates by reference to the NAIC Financial Conditions Framework.

The SVO shall have no authority to issue NAIC Designations or any other NAIC analytical product to an insurance company for a Regulatory Transaction under this Section 2 (a).

See Part Three, Section 3 (d) below for the definition of Regulatory Transaction and a description of the processes governing their assessment.

© 2015 National Association of Insurance Commissioners

(Rev 01/13)
(b) Authority to Require a Filing with the SVO

The existence of a filing exemption for a transaction, security, financial asset or investment activity in any Part of this Manual is not intended to, and shall not be read as, prohibiting a state insurance regulator from requiring its domiciled insurance company to file a transaction, security, financial asset or investment activity with the SVO for analysis.

In addition, nothing in this Manual should be read as prohibiting a state insurance regulator from asking for SVO or SSG analytical assistance with respect to any investment related activity, or in connection with assessment of investment related aspects of a Regulatory Transaction, as defined in Part Three, Section 3 (e) of this Manual and directing an insurance company to file relevant information with the SVO or the SSG for that purpose.

Part Three – Credit Assessment

Section 2. Corporate Bonds and Preferred Stock – Special Assessment Situations

Bonds and preferred stock that fit the description set out below shall be subject to the general procedures specified above as well as the specific or special procedures identified below.

(d) SCA Debt and Preferred Stock

Part Five, Section 2 of this Manual governs valuation of Subsidiary, Controlled and Affiliated (SCA) investments in the form of common stock and in the form of preferred stock issued by an insurance company. This section applies to credit assessment of any SCA investment in the form of a debt instrument purchased (or otherwise acquired) from an insurance or non-insurance entity (“SCA debt”) and preferred stock issued by a non-insurer entity (“SCA preferred stock”). This procedure is used to determine whether an SCA debt or SCA preferred transaction is eligible for reporting as an Investment Security pursuant to Part Two Section 2 (a) of this Manual.

…

(e) Regulatory Transactions

i. Defined - Regulatory Transaction means a security or other instrument in a transaction submitted to one or more state insurance departments for review and approval under the regulatory framework of the state or states.

ii. Intent - This Section provides guidance to the SVO and the SSG on how to manage requests for assistance made by a state insurance department under Part Two, Section 2 (b) of this Manual.

iii. Guidelines

The SVO or SSG is authorized to conduct an analytical assessment on behalf of any state insurance department that requests such assistance.

If an insurance company files a Regulatory Transaction with the SVO via the ATF process or under the RTAS process, the SVO shall first contact the state insurance department of the insurance company’s state of domicile to disclose that a Regulatory Transaction has been submitted and inquire whether the state insurance department wants SVO analytical assistance.

If the state insurance department of the insurer’s state of domicile request such assistance, the SVO shall engage in the requested analytical assessments of the Regulatory Transaction. SVO determinations may include and refer to NAIC analytical benchmarks, such as NAIC Designations, valuation or classification assessments and such determinations may be given by the SVO or SSG to the state insurance department.
SVO or SSG determinations given in connection with the assessment of a Regulatory Transaction may be given to and adopted by the state insurance department as part of that state’s internal determination of the regulatory issues presented by the Regulatory Transaction. However, SVO assessments for a Regulatory Transaction will not be entered into NAIC computer systems reserved for Investment Securities, as defined in Part Two, Section 2 (a) or added to the SVO List of Securities as defined in Part One, Section 3 (g).