



Car' B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation
(202) 624-2118 t (866) 953-4096 f
car.wilkerson@acli.com

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
Ci Oquendo 12
28006 Madrid
Spain

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Re: Margin Requirements for Non-Centrally Cleared Derivatives: BCBS-IOSCO Consultative Document (July 2012)

To the Basel Committee on Banking Supervision and the International Organization of Securities Commissions:

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry in the United States. Life insurers use derivatives to responsibly manage asset and liability risks. Life insurers actively participated in the U.S. legislative dialogue concerning regulation of derivatives markets and have provided constructive input on proposed rulemaking implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Because many aspects of the BCBS and IOSCO Consultative Document endeavor to establish harmonized international standards governing derivatives transactions¹, we greatly appreciate the opportunity to share the views of the life insurance industry on these important matters.

Our submission discusses the following topics: (i) life insurers' use of derivatives to manage asset and liability risks; (ii) a summary and analysis of selected topics in the Consultative Document; and, (iii) responses to specific questions posed in the Consultative Document.

¹ The consultative document presents the initial policy proposals emerging from the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) joint Working Group on Margining Requirements. These proposals would establish minimum standards for margin requirements for non-centrally-cleared derivatives.

I. Life Insurers' Use of Derivatives to Manage Asset and Liability Risks

Life insurers' financial products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care insurance and disability income insurance, among other products. These products provide consumers with financial security through various stages of life and enable them to plan for their financial future, including retirement. Many life insurer obligations to policyholders as well as the assets that are purchased to support those liabilities have durations that extend for one or more decades. Life insurers, therefore, carefully manage risks associated with long term assets and liabilities with derivatives.² The regulatory status of derivatives, thus, is critically important to the life insurance industry.

Insurers use a diverse group of financial derivatives, from standardized derivatives, exchange-traded government bond futures and over-the-counter ("OTC") vanilla interest rate swaps, to customized derivatives, like structured currency swap and equity option transactions. Although standardized derivatives are a core hedging tool for life insurers, they do not offer the flexibility and cost efficiency needed to fully manage risks associated with the full range of insurers' assets and liabilities. Such risks include the risk of changes in value, yield, price, cash flow, quantity of assets, liabilities, and foreign currency exchange risk. In order to mitigate such risks, life insurers actively participate in both the exchange-traded futures and options markets and OTC, bilaterally negotiated markets. Consequently, customized derivatives account for a large portion of insurers' OTC derivatives usage and are utilized to provide a closer offset to the market risks of insurance products that are tailored to fit customer needs and to precisely hedge risk in assets held to manage insurance liabilities.

Life insurers execute their customized derivatives with prudent credit support arrangements that require exposures to be netted and collateral to be posted between the parties. In this manner, insurers and their counterparties are able to effectively reduce and control the counterparty credit risk arising from customized OTC derivatives.³ For most of insurers' existing OTC transactions, no initial margin or independent amount is required and variation margin is exchanged on a daily basis. Furthermore, in response to the financial crisis, many life insurers renegotiated their OTC agreements to reduce or eliminate thresholds for posting collateral. As a result, their derivatives

²Because they are unique, major institutional investors, life insurers are indispensable to American businesses and state and local governments, allowing them to cost-effectively raise capital. Moreover, these investments support life insurers' obligations to provide retirement and financial security for millions of Americans. The derivatives markets are instrumental to both of these functions. Many of the assets and risks insurers face cannot be managed with standardized or exchange traded derivatives. Efficient and cost-effective access to the OTC derivatives markets is fundamental to life insurers' ability to responsibly manage risks.

³Restrictions or prohibitions on the use of customized OTC derivatives would create unnecessary, non-economic frictional costs for delivering life insurance, long term care, and retirement savings products to millions of Americans. In some instances, products would need to be priced higher or removed from the market altogether if risks cannot be hedged effectively. Ultimately, policyholders would incur greater expenses or be unable to acquire products to manage their retirement savings, estate planning, or long-term care coverage.

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exposures are generally fully collateralized with the exception of one day market value movements and pose minimal risk to the financial markets.

Life insurers' use of derivatives is limited by detailed regulation in each state and jurisdiction in which insurers operate. These laws and regulations restrict life insurers' use of derivatives to hedging and replication transactions, and impose significant transparency and collateralization requirements. These long-standing regulatory mandates fully match the functional and operative core of Title VII of the Dodd-Frank Act and other comparable derivatives regulations that are designed to prevent financial and economic instability attributable to derivatives transactions.⁴

II. Summary and Analysis of Selected Topics in the Consultative Document

A. Impact of Margin Requirements on Liquidity

The Consultative Document states that the potential benefits of margin requirements must be weighed against the liquidity impact that would result from derivative counterparties' need to provide liquid, high-quality collateral to meet those requirements, including potential changes to market functioning as result of an increasing demand for such collateral in the aggregate. The document notes that financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. Moreover, the document observes that liquidity impact of margin requirements cannot be considered in isolation.

As a general matter, the Consultative Document emphasizes that all derivatives not centrally-cleared by a central clearing party (CCP) should be subject to margining requirements. In principle, the document indicates this includes all five major asset classes of derivatives (interest rate, credit, equity, foreign exchange and commodity) and all derivative products (both standardized and bespoke) that are not centrally cleared by a central counterparty for any reason.⁵

⁴ Through a network of statutes and regulations, state insurance departments heavily regulate the operations, products, solvency, market conduct and financial condition of life insurance companies. Life insurers must fulfill this regulatory structure in their state of domicile and in every jurisdiction in which they distribute their financial products. Uniformity of regulation is accomplished throughout the states by means of model statutes and regulations developed by the National Association of Insurance Commissioners (the "NAIC"). Many of the insurance statutes and regulations promulgated and enforced by state insurance departments fulfill regulatory goals parallel to federal regulators. The broad scope and comprehensiveness of these state insurance statutes and regulations achieves functional harmonization and prevents regulatory arbitrage. Each jurisdiction regularly examines life insurers on financial condition and market conduct, and ensures that laws and regulations are properly followed.

To provide further context for the Regulators on the state regulation of insurers' derivatives activities, we attach as Appendix A an outline of the National Association of Insurance Commissioners' ("NAIC") Investments of Insurers Model Act which shows the breadth and depth of regulatory oversight of derivatives transactions. In addition, as Appendix B we provide portions of the NAIC's Financial Condition Examiner's Handbook that provides guidance to examiners in reviewing an insurer's derivatives activities. Finally, as Appendix C we show sample pages from an insurer's annual statutory financial statements where all derivatives transactions must be reported. These documents demonstrate that insurers' use of derivatives is carefully regulated and routinely examined by, as well as transparently reported to, state insurance regulators.

⁵ The Consultative Document establishes initial policy proposals for margin requirements for non-centrally-cleared derivatives through key principles addressing seven main elements:

1. Appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.

We fully agree with the Consultative Document's position that the potential benefits of increased margin requirements must be evaluated in light of the liquidity impact that would result from the substantial increase in derivative counterparties' obligation to provide liquid, high-quality collateral to meet those requirements and the potential market changes as a result of the increasing demand for such collateral.⁶

The Consultative Document's focus on the impact of margin requirements on liquidity reflects a prudent approach to designing margin requirements for uncleared swaps.

B. Eligible Collateral for Margin

The Consultative Document discusses two means to define eligible collateral. One approach would limit eligible collateral to only the most liquid, highest-quality assets, such as cash and high-quality sovereign debt, on the grounds that doing so would best ensure the value of collateral held as margin could be fully realized in a period of financial stress.

A second approach would permit a broader set of eligible collateral, including assets like liquid corporate bonds and equity securities, and address the potential volatility of such assets through

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2. All financial firms and systemically-important non-financial entities ("covered entities") that engage in non-centrally-cleared derivatives must exchange initial and variation margin as appropriate to the risks posed by such transactions.
 3. The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the proposed requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally-cleared derivatives at issue and (ii) ensure that all exposures are covered fully with a high degree of confidence.
 4. To ensure that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.
 5. Initial margin should be exchanged by both parties, without netting of amounts collected by each party (i.e. on a gross basis), and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.
 6. Transactions between a firm and its affiliates should be subject to appropriate variation margin arrangements to prevent the accumulation of significant current exposure to any affiliated entity arising out of non-centrally-cleared derivatives.
 7. Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions.

⁶ ACLI's July 11, 2011 [submission](#) to the CFTC and U.S. prudential regulators noted that limiting eligible collateral to cash and government securities could impose unintended negative consequences on the market for these securities, and could create liquidity log jams. See ACLI submission at 6. In the submission, ACLI emphasized that limiting non-cash eligible collateral to U.S. Treasuries and guaranteed agency securities may also alter the markets for these securities -- artificially increasing prices due to rising demand and suppressing yields for investors in these securities. There could be new sensitivity in the markets for these securities which could lead, in times of market stress, to increased volatility which could ripple across the financial markets. Increased demand for U.S. Treasuries as eligible collateral would be exacerbated by the "flight to quality" in times of market turmoil or distress. Otherwise sound firms could potentially be placed into a scenario where they are forced to liquidate other high quality asset types to fulfill increasing margin requirements with a narrowly defined collateral universe. Being able to avoid this type of scenario is arguably a primary reason behind the wide range of eligible collateral types available at the Federal Reserve Discount Window.

application of appropriate haircuts to their valuation for margin purposes. The Consultative Document observes that potential advantages of the second approach would include (i) a reduction of the potential liquidity impact of the margin requirements by permitting firms to use a broader array of assets to meet margin requirements and (ii) better alignment with central clearing practices, in which CCPs frequently accept a broader array of collateral, subject to collateral haircuts. After evaluating each of these alternatives, the BCBS and IOSCO have proposed the second approach allowing broader eligible collateral.

ACLI fully supports the second approach in the Consultative Document to broadly define collateral eligible for margin. The second approach dovetails with recommendations ACLI made to U.S. regulators on this matter.⁷

Permitting a broader list of eligible collateral for both initial and variation margin would achieve the intent of securing derivatives positions and minimizing the liquidity stress on the marketplace and other unintended consequences described above. In sum, therefore, we strongly support the Consultative Document's approach allowing broader categories of eligible.

⁷ In our July 11, 2011 comment letter to the CFTC and U.S. prudential regulators, we explained that ACLI developed a proposal based on an analytic framework that utilizes basic portfolio diversification techniques on corporate bonds to demonstrate, almost to the level of statistical certainty, that high quality corporate collateral would provide enough cushion even against some of the most severe economic downturns. A brief summary of ACLI's approach in our July 11, 2011 comment letter may provide helpful context. In light of the Dodd Frank Act's prohibition on relying on credit ratings provided by nationally recognized statistical rating organizations (NRSROs), ACLI's proposal uses the Barclays U.S. Credit Index, a broad-based index containing 4,430 issues/CUSIPs representing an outstanding amount of \$3.4 trillion. The Barclays U.S. Credit Index (together with its predecessor, the "Barclays Index") has many advantages, including clearly defined eligibility rules, a defined list of eligible CUSIPs limited to large liquid issues and a ready source of daily pricing and historical data. The Barclays Index is also widely benchmarked by money managers evidencing wide acceptability by other financial end users. In addition, the Barclays Index is one of many indices that are available to reference high-quality, U.S. corporate bonds and our analysis could be applied to other indices as well.

Following the Prudential Regulators' position that termination (close out) of uncleared derivatives and liquidation of collateral could take ten days in a stress scenario, we analyzed individual CUSIPs from the Barclays Index during 2008 and found that nearly 20% of CUSIPs experienced a ten-day price decline in excess of 20% with a maximum decline in excess of 90% in 0.2% of the CUSIPs, leading to the conclusion that tail events, though rare, do occur. Thus, a collateral pool consisting of one CUSIP is not advisable.

In expanding the analysis to look at the impact of adding additional CUSIPs to the collateral pool, ACLI chose a single month (September 2008) to ensure a continuous set of CUSIPs and selected a random portfolio as of September 1, 2008, subject to diversification rules limiting each issuer to a specified percentage and each broad sector (Financial Institutions, Industrials, Utilities, Transportation, Agencies, Local Authorities, Sovereign and Supranational) to no more than 45% of the portfolio. The market value of the equally weighted portfolio was calculated as it evolved through the month, including the largest 10-day (rolling) price drop that occurred during the month.

The analysis shows that corporate bond tail risk can be controlled with basic diversification rules (e.g., minimum of 20 CUSIPs and 45% concentration limit per High Level Sector) and that collateral haircuts of 15-20% provide a high degree of protection upon the occurrence of a CSE default. The maximum decline at the 99th percentile was 10.25% in our portfolio simulation. We also learned that further diversification beyond these rules provided little incremental benefit while substantially increasing operational burdens. Our analysis shows that high quality corporate bonds, appropriately haircut and diversified, can be prudently included as eligible collateral for cleared and uncleared derivative exposure. We also suggest that other high-quality collateral types such as Agency Debentures and Agency RMBS should also be included as eligible collateral. Our proposal recommended prudent haircuts, portfolio diversification and concentration limits to further support an expanded list of eligible collateral.

D. Proposed Examples of Eligible Collateral

As a guide, the Consultative Document provides examples of the types of eligible collateral that satisfy the key principle would generally include:

- Cash;
- High quality government and central bank securities;
- High quality corporate bonds;
- High quality covered bonds;
- Equities included in major stock indices; and
- Gold.

The Consultative Document notes that

The illustrative list above should not be viewed as being exhaustive. Additional assets and instruments that satisfy the key principle may also serve as eligible collateral. Also, in different jurisdictions, some particular forms of collateral may be more abundant or generally available due to institutional market practices or norms. Eligible collateral can be denominated in any currency in which payment obligations under the non-centrally-cleared derivative may be made, or in highly-liquid foreign currencies subject to appropriate haircuts to reflect the inherent FX risk involved.

ACLI strongly supports the examples of eligible collateral listed in the Consultative Document in fulfillment of the document's key principle, and endorses the statement that the illustrative list is not exhaustive. We agree that additional assets and instruments, such as Residential Mortgage-backed Securities and Commercial Mortgage-Backed Securities may also satisfy the Document's key principle, and should be evaluated by regulators as eligible collateral. A broad range of eligible high-quality collateral, with appropriate concentration limits, diversification constraints and haircuts, will prudently assure satisfaction of counterparty obligations while also enhancing liquidity in the market.

D. Key Principle on Margin in Consultative Document

To ensure assets pledged as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect secured parties covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default, the Consultative Document explains that these assets should be highly liquid and should, after accounting for an appropriate haircut, maintain their value in a time of financial stress.⁸ The Consultative Document recommends that securities issued by the counterparty or its related entities should not be accepted as collateral. The document further notes that accepted collateral should also be reasonably diversified.

⁸ The Consultative Document recommends the set of eligible collateral should recognize that assets that are liquid in normal market conditions may rapidly become illiquid in times of financial stress. In addition to having good liquidity, eligible collateral should not be exposed to excessive credit, market and FX risk. To the extent that the value of the collateral is exposed to credit, market, liquidity and FX risks (including through differences between the currency of the collateral asset and the currency of settlement), appropriately risk-sensitive haircuts should be applied. More importantly, the value of the collateral should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally-cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected (i.e. the so-called "wrong way risk").

We support the concepts in the Consultative Document that assets pledged as collateral for initial and variation margin should be capable of being liquidated in a reasonable amount of time, even under adverse market conditions to protect collecting entities against a counterparty's default. As noted above, we support reasonable diversification in accepted collateral.

E. Consultative Document Commentary on Margin Standards Across Jurisdictions

The Consultative Document states that:

Market conditions and asset availability differ across jurisdictions. National supervisors should develop their own list of eligible collateral assets based on the key principle, taking into account the conditions of their own markets and making reference to the list of examples of eligible collateral under the proposed requirement section. Allowing jurisdictions to develop their own list of eligible collateral assets is expected to reduce margining requirements' impact on the liquidity and prices of eligible assets, reduce concentration risk, and provide sufficient flexibility to permit new assets to serve as collateral in the future as markets evolve.

Subject to meeting the key principle, the scope of eligible collateral assets should be kept broad, with appropriate haircuts. It is expected that demand for high quality liquid assets may increase with the implementation of various regulatory reforms, including central-clearing, margin requirements for non-centrally-cleared derivatives and Basel liquidity requirements. Keeping the scope of eligible assets broad may help relieve pressure on the supply of eligible collateral assets. It may also help avoid concentration risks.

Haircut requirements should be transparent and easy to calculate, so as to facilitate payments between counterparties, avoid disputes and reduce overall operational risk. Haircut levels should be risk-based and should be calibrated appropriately to reflect the underlying risks that affect the value of eligible collateral, such as market price volatility, liquidity, credit risk and FX volatility, during both normal and stressed market conditions.

Given the diversity of eligible collateral assets, there may be practical difficulties for supervisors to stipulate in advance the haircut level for each type of collateral. The pre-determined haircut levels may also become outdated as market conditions change. Adopting internal or third party models that have been approved by supervisors to calculate haircut level may, therefore, be desirable. However, some firms may be unable or unwilling to develop internal haircut calculation models that meet regulators' requirements. To provide a conservative alternative in those cases, the Consultative Document proposes a set of standardized haircuts that can be used in lieu of model-based haircuts.

ACLI strongly supports the recommendations in the Consultative Document that the scope of eligible collateral should be kept broad, with appropriate haircuts. Alternatives reflecting internal or third party haircut models coextensively with a set of standardized haircuts that can be used in lieu of model-based haircuts provide a sound and responsible flexibility.

F. Inter-Affiliate Swap Transactions

The Consultative Document suggests that transactions between a firm and its affiliates should be subject to appropriate variation margin arrangements to prevent the accumulation of significant current exposure to any affiliated entity arising out of non-centrally-cleared derivatives. The document expresses the view that requiring variation margin on inter-affiliate transactions is advisable as it presents no net cost to a corporate group but does protect against the possibility that one affiliate builds up a large and uncollateralized exposure to another affiliate or parent that could jeopardize the entire corporate group.

The Consultative Document notes, however, that despite the BCBS and IOSCO consensus view and proposal that variation margin be required on transactions between affiliates, some members believe that an exchange of variation margin is not necessary between affiliates, subject to compliance with specific criteria specified by the appropriate supervisory authority (e.g., requirements that the affiliates share the same appropriate centralized risk evaluation, measurement and control procedures, the affiliates are included in the same financial statements on a fully consolidated basis, and there is no current or foreseen material practical or legal impediment to the prompt transfer of funds or repayment of liabilities between the affiliates). In view of this equivocal reaction from its members, BCBS and IOSCO have requested input on the appropriate treatment of inter-affiliate trades.

We believe as a general matter that requiring variation margin between affiliates within a corporate group does not reduce systemic risk and does not increase safety and soundness of the financial system, provided of course, that the outward facing, net exposure of the corporate group is fully margined with initial margin and variation margin. Inter-affiliated entities that are by definition part of a corporate group should be responsible for management of their affiliate-facing credit risks without additional oversight from regulators. Transfer of variation margin between affiliates does not effect a substantive reduction of credit risk because there is no impact on outward facing credit risk. Rather, within a corporate group, liquidity should not be constrained and funds should be allowed to flow among the affiliates, subject to prudent risk management policies and procedures and in the case of regulated entities such as insurers, existing regulatory obligations. Requiring variation margin between affiliates would increase costs to the corporate group and be an exercise in form without substantive risk reduction.⁹

G. Universal Two-way Margin Requirements

The Consultative Document indicates that a majority of the BCBS and IOSCO members supported margin requirements that, in principle, would involve the mandatory exchange of both initial and

⁹ The CFTC has specifically addressed this matter in the context of potentially clearable swaps among affiliated entities. See, 77 Fed. Reg. 50425 (Aug. 21, 2012) [Clearing Exemption for Swaps Between Certain Affiliated Entities]. In its rule proposal, the CFTC distinguished between corporate groups that are 100% wholly-owned and commonly guaranteed and those that are not. According to the rule proposal, the former corporate group would be exempted from having to exchange variation margin and the latter type of group would not be. While we respectfully disagree with any variation margin requirement within a majority owned corporate group and also believe that the commonly guaranteed language is unnecessary, we suggest that the proposed 100% wholly-owned exception be extended to both clearable and non-clearable swaps with the corresponding deletion of the commonly guaranteed language that could restrict flexibility in how centralized derivatives entities are organized within the structure of a corporate group.

variation margins among parties to non-centrally cleared derivatives, which was labeled as “Universal Two-way Margin.” BCBS and IOSCO recognized that two-way margining would impose substantial liquidity costs, and that the use of thresholds could potentially balance the policy goals of reducing systemic risk and promoting central clearing with mitigating the costs of bilateral margin exchange. BCBS and IOSCO considered a variety of options for implementing universal two-way margin. The Consultative Document, however, revealed that no unanimous view developed on the design and calibration of thresholds to achieve an optimal compromise between liquidity burdens and reduced systemic risk.¹⁰

Based on thorough discussions with market participants, ACLI believes that swap dealers and financial firms should have the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impacts of Initial Margin Requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over Initial or Variation Margin.

In sum, therefore, ACLI broadly supports two-way margin requirements between swap dealers and financial firms in variation margin, while providing flexibility for the parties to determine whether and to what extent Swap Dealers and Major Swap Participants should be required to pledge Initial margin to financial firms. We also recommend that the parties have the right to determine the protections afforded to initial margin pledged by financial firms to swap dealers and Major Swap Participants, which could include placement in third-party custodial or Tri-party Accounts, and note that liquidity concerns can be addressed in part by establishing appropriate initial margin requirements and broadening eligible collateral types.

¹⁰ In our July 11, 2011 comment letter to the CFTC, ACLI emphasized that two-way posting between CSEs and financial end users is of particular significance to the life insurance industry. It is customary practice for life insurers to require two-way posting of variation margin in the OTC market, which enhances the safety and soundness of life insurance companies in a manner consistent with the regulatory scheme to which they are subject, thereby enhancing the stability of the financial system as a whole. In our comment letter, ACLI strongly supported the CFTC’s approach to two-way variation margin over the prudential regulator’s disinclination for two-way margining.

ACLI emphasized the CFTC’s observation that the imposition of a two-way margin requirement will *enhance* the stability of CSEs and the financial system for a number of reasons, including:

- Two-way margin removes each day’s exposure from the marketplace for all products and all participants and prevents CSEs from accumulating obligations they cannot fulfill; and,
- Unchecked accumulation of exposures was a contributing factor to the financial crisis that led to the enactment of the Dodd-Frank Act.

II. Responses to Specific Questions Posed in the Consultative Document

A. Implementation and Timing of Margin Requirements

Question 1. *What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?*

Response to Question 1. The implementation timeline can and should be set independently from central clearing mandates in order to allow financial end-users reasonable time frame to adapt to initial margin requirements and negotiate legal documentation changes with dealers who are likely to focus initially on swaps that are required to clear, and with onboarding other Swap Dealers and high volume end-users.

B. Element 1: Scope of Coverage – Instruments Subject to the Requirements

Question 2. *Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Response to Question 2. There should be no distinction between physically settled and non-deliverable forwards.

Question 3. *Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?*

Life insurers strongly support global harmonization of derivatives regulation and prevention of regulatory arbitrage. We strongly recommend an exclusion for products issued by life insurance companies that closely tracks the non-exclusive safe harbor provided by the CFTC in its recently adopted definition of the term “swap.”¹¹ Additionally, like the CFTC swap definition, the rule should contain a flexible approach, such as a non-exclusive safe harbor exclusion, so that the regulatory provisions organically encompass newly developed products without the need for rule amendment.

C. Element 2: Scope of Coverage – Scope of Applicability

Question 4. *Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting*

¹¹ See the CFTC's adoption of its swap definition in Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps: Security-Based Swap Agreement Recordkeeping [<http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf>], which provided two approaches to excluding insurance products from the swap definition: (i) based on a products test and an insurance company provider test, and alternatively, (ii) a non-exclusive safe harbor for “enumerated categories” of products issued by life insurers meeting the provider test. The enumerated categories of products issued by life insurers include life insurance, annuities, long term care insurance and disability insurance. Additionally, the new definition excludes reinsurance of products entitled to exclusion under the rule.

central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

Response to Question 4. Life insurers broadly support two-way variation margin between financial firms and Swap Dealers as a balance of policy goals. As explained above in Section III (G) of this letter, swap dealers and financial firms should have the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impacts of Initial Margin Requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over Initial or Variation Margin. Liquidity concerns can be addressed by setting appropriate initial margin requirements and broadening eligible collateral types as discussed above in Section III. Any initial margin should be placed in third-party custody. Variation margin should be allowed to flow through without restrictions.

Question 5. *Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?*

Response to Question 5. Market participants should have the ability to provide for Non-Zero margin thresholds. Margin thresholds are not inconsistent with a central clearing mandate because other factors exist, such as higher levels of initial margin for uncleared trades, that provide incentives to clear trades.

Question 6. *Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, e.g. G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?*

Response to Question 6. Although differing initial margin thresholds may impact pricing, such impacts should be reasonable based on the increased risk created by such thresholds. Life insurers do not believe that systemic risk can be measured based on notional size or amount of trades because some large trades may contain a feature that makes them uncleared, even though a liquid market may exist for such securities. Conversely, a smaller trade may be highly leveraged

and illiquid creating more risk relative to its notional amount. Standard initial margin requirements should apply to each counterparty regardless of their creditworthiness.

Question 7. *Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e. those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?*

Response to Question 7. Life Insurers do not agree that thresholds should be limited to prudentially regulated entities. As more fully discussed above in Section I of this letter and the accompanying Appendix materials, life insurers are comprehensively regulated under state insurance laws and regulations administered by state insurance departments. Collectively, these laws and regulations prevent regulatory arbitrage, achieve detailed functional regulation, and ensure that life insurers' derivatives transactions fulfill the goals of the Dodd-Frank Act, including transparency and collateralization. Accordingly, any definition of prudentially regulated entities must include life insurers subject to U.S. state insurance regulation.

Question 8. *How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?*

Response to Question 8. Market participants should have the ability to determine the methodology for non-zero margin. Market participants that use standardized initial margin calculations should be able to use this methodology.

Question 9. *What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?*

Response to Question 9. As discussed more fully above in Section II of this letter, permitting a broader list of eligible collateral for both initial and variation margin would achieve the intent of securing derivatives positions and minimizing the liquidity stress on the marketplace and other unintended consequences. Life insurers currently engage in two-way margining that allows posting of high quality corporate debt and RMBS as collateral. These practices are critical to avoid draining capital and liquidity from the system while protecting financial end-users of derivatives. Not requiring or permitting two-way margining would be a significant change in market practice, and would be especially inimical to managing risks associated with life insurers' long-term assets and liabilities.

Question 10. *What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate*

systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

Response to Question 10. As long as parties can post a broader range of collateral and net exposures across product types and between pre and post effective date uncleared swaps, these positions will mitigate the need to provide initial margin, which is a new practice for most market participants. Without these provisions, margining regardless of whether it is two-way or not, will become substantially more complex. It is important, therefore, to give swap dealers and financial firms the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impacts of initial margin requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over Initial or Variation Margin. This matter is more fully discussed above in Section II (G) of this letter.

D. Element 3: Baseline Minimum Amounts and Methodologies for Initial and Variation Margin

Question 13. *Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?*

Response to Question 13. Life insurers support the principal that the selection of an initial margin model and changes to that model have to be transparent and agreed to by both parties, and that the methodology needs to be open to allow for the reciprocal calculation of margin requirements. Initial margin for purchased Credit Default Swaps and equity should be limited to the net present value (NPV) of premiums outstanding.

Question 14. *Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

Response to Question 14. The current practice for life insurers in transactions with counterparties is to net variation margin across asset classes. This process has worked well without problems for a considerable amount of time. Changing this long-standing practice would raise significant and unnecessary liquidity, capital and systemic risk concerns. We oppose, therefore, model-based initial margin calculations that mandate diversification benefits to be operative within broad asset classes and not across such classes.

Question 15. *With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?*

Response to Question 15. The time period of a 10-day horizon with a 99 percent confidence interval is too long, because nearly all swaps can be unwound in difficult market conditions within one business day, and the most complex swaps can be unwound within five business days. Margins calculated as a percentage of notional exposure, therefore, are not appropriate. Additionally, such time horizons would require approximately double the margin for swaps as for comparable futures.

Question 16. *Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?*

Response to Question 16. Life insurers strongly urge that methodologies for calculating variation margin must be transparent, agreed upon by both parties, open to allow for the reciprocal calculation of margin requirements.

Question 17. *With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?*

Response to Question 17. Life insurers support daily variation margin payments, but would oppose intra-day margin payments because of intra-day payments would impose burdensome, unnecessary logistics with inherent calculation disparities.

Question 18. *Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?*

Response to Question 18. Additional Margin should be discouraged in all but the most severe circumstances, because the imposition of additional margin could be abused by Swap Dealers against financial end-users. Procyclicality is reduced by limiting or prohibiting financial issuers (e.g., banks) from the permitted basket of corporate bond collateral.

Question 19. *What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?*

Response to Question 19. Life insurers support a minimum transfer amount of \$1 million, which dovetails with requirements under New York law, and we support standards allowing counterparties to negotiate the minimum transfer amount based upon evaluations of operational risk and uncollateralized exposure in individual sets of circumstances.

E. Element 4: Eligible Collateral for Margin

Question 20. *Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?*

Response to Question 20. Life Insurers broadly agree with the expanded categories of collateral types in the Consultative Document. We recommend, however, revising the definition for corporate bonds to encompass corporate bonds included in high quality major bond indices. The demands for increased collateral due to initial margin accentuate the need for expanded collateral types, as discussed more fully above in Section II (A) and (B) of this letter.

Question 21. *Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?*

Response to Question 21. Diversification requirements, and other specific requirements, are best handled through negotiations between counterparties who are best suited to judge the adequacy of haircuts. It is noteworthy to emphasize that the level of appropriate diversification is directly related to the haircut level set in the transaction.

F. Element 5: Treatment of Provided Margin

Question 22. *Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?*

Response to Question 22. Market participants should have the right to choose their level of protection Legally Segregated Operationally Commingled (LSOC) or Complete Segregation with minimum requirements. Flexibility should be permitted in appropriately achieving protection of margin (e.g. LSOC or complete segregation at the option of end users.)

Question 23. *Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?*

Response to Question 23. Margin exchange on a gross basis will substantially increase margin levels and increase concentration risk. Life insurers strongly support, therefore, margin exchange on a net basis. Alternatively, initial margin netted by product class would make more sense.

Question 24. *Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?*

Response to Question 24. Parties should be allowed to negotiate re-hypothecation rights on Initial and variation margin with swap dealers based on an analysis of relevant individual facts and circumstances. Segregation of collateral from a dealer's proprietary assets worked well during the 2008-09 financial crisis and strikes a sensible balance between complete segregation with Control Accounts and unrestricted use of collateral.

G. Element 6: Treatment of Transactions with Affiliates

Question 25. *Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?*

Response to Question 25. As more fully discussed above in Section II (F) of this letter, we note as a general matter that requiring variation margin between affiliates within a corporate group does not reduce systemic risk and does not increase safety and soundness of the financial system, provided of course, that the outward facing, net exposure of the corporate group is fully margined with initial margin and variation margin.

Question 26. *Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?*

Response to Question 26. See response to Question 25.

H. Element 7: Interaction of National Regimes in Cross-Border Transactions

Question 27. *Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?*

Response to Question 27. Life insurers strongly support the elimination of regulatory arbitrage in all transactions through harmonized regulatory standards, including cross-border transactions.

Conclusion

ACLI supports harmonized international standards for initial and variation margin in uncleared swaps transactions.¹² We strongly support the concepts from the Consultative Document, including enlarging the scope of eligible collateral and focusing on the impact of margin requirements on liquidity. ACLI concurs with the Consultative Document's strong support for universal two-way variation margining and a flexible approach with respect to initial margin requirements for Swap

¹² The BCBS and IOSCO Consultative Document contains several important elements very relevant to the CFTC's proposed rule that would establish initial and variation margin requirements on uncleared swaps for Swap Dealers and Major Swap Participants. See 76 Fed. Reg. 82 (April 28, 2011) at 23732; <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf>. ACLI has encouraged the CFTC and U.S. prudential regulators to work carefully to incorporate the regulatory harmonization concepts discussed above from the consultative Document, with particular emphasis on enlarging the scope of eligible collateral in derivatives transactions in order to avoid unintended consequences.

ACLI Submission on BCBS-IOSCO Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (September 28, 2012)

Dealers and Major Swap Participants to mitigate the impact on liquidity. We support alignment of margin requirements for uncleared swaps globally, especially between major market jurisdictions. All of these matters will lower the risk of financial entities, and prevent regulatory arbitrage.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

CC: Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. Alfred M. Pollard, General Counsel
Attention Comments/ RIN-AA45
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Mr. Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Mr. David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

The Use of Derivative Financial Instruments by Life Insurers Under State Insurance Law

Carl B. Wilkerson, Vice President & Chief Counsel- Securities & Litigation
American Council of Life Insurance

I. The National Association of Insurance Commissioners (NAIC) Investments of Insurers Model Acts Govern Derivatives Transactions by Life Insurers

A. Purpose of Investment Law Provisions, as noted in the NAIC Investments of Insurers Model Act (*Defined Limits Version*) (1996):

1. The development of regulation of the investments of insurers requires an analysis of the complexities, uncertainties, competitive forces and frequent changes in the investment markets and in the insurance business, the diversity among insurers, and the need for a balance among risk, reward and liquidity of an insurer's investments. NAIC Model Reporting Service, Vol. II, Section 1, at 280-1.
2. It also requires an analysis of how to safeguard the financial condition of domestic insurers and at the same time to permit domestic insurers to be competitive with insurer's domiciled in other states and with other financial industries that operate under different regulatory regimes. *Id.*
3. The NAIC advises each state to determine through independent study which methods are best suited to its needs and whether its existing regulatory structure may be improved by using provisions of model laws recommended by the National Association of Insurance Commissioners (NAIC) or existing regulatory structures in other states or industries. *Id.*
4. This model law is not considered by the NAIC to exhaust regulatory methods to address the regulation of investments of insurers. Nor is this model law recommended by the NAIC to be used as a standard for the examination of insurers unless *substantially similar* provisions are found in the statutes and regulations of the state of domicile of the insurer. *Id.* (emphasis added).

B. The NAIC has addressed these goals with two different approaches:

1. The NAIC Investments of Insurers Model Act (*Defined Limits Version*) sets forth specific limits on insurers investments, including derivatives, and is discussed below.
2. A second alternate choice exists in the NAIC Investments of Insurers Model Act (*Defined Standards Version*) which implements modern portfolio management practices.
 - a. The Defined Standards version serves as an alternative to the Defined Limits version of the Investments of Insurers Model Act

which requires that investments be made only in assets that are specifically identified and with quantitative limits for assets invested in each category.

- b. The Defined Standards version provides a “prudent person” approach to investments that implements modern portfolio theory, and establishes the following type of investment authority:
 - (1) An insurer is obligated to fulfill the “minimum asset requirement” as that term is defined in the model act.
 - (a) The minimum asset requirement is made up of an insurer’s liabilities and what is called the “financial security benchmark.”
 - (b) This benchmark equals either the company’s minimum capital surplus as required by statute or the authorized control level risk-based capital which applies to the insurer as set forth in the risk-based capital law of the state, whichever is greater; and,
 - (2) An insurer invests its assets after fulfilling the minimum asset requirement according to a prudence standard. The Defined Standards version establishes factors that must be evaluated and considered by the insurer in determining whether its investment portfolio is prudent.

C. Overview of the Investments of Insurers Model Act (Defined Limits Version) and its application to derivatives

1. Scope

- a. That applies only to investments and investment practices of domestic insurers and United States branches of alien insurers entered through the individual states.
- b. The Act does not apply to investments for separate accounts of an insurer except to the extent the provisions of the NAIC Model Holding Compact so provide.

2. Purpose to the defined limits version

- a. The purpose of this Act is to protect the interests of insureds by promoting insurer solvency and financial strength. This will be accomplished through the application of investment standards that facilitate a reasonable balance of the following objectives:
 - (1) To preserve principal;
 - (2) To assure reasonable diversification as to type of

investment, issuer and credit quality; and

- (3) To allow insurers to allocate investments in a manner consistent with principles of prudent investment management to achieve an adequate return so that obligations to insureds are adequately met and financial strength is sufficient to cover reasonably foreseeable contingencies.

3. Treatment of Derivatives

- a. Article II Section 18 governs derivative transactions
- b. The NAIC Commentary indicates that derivatives by insurers should be limited to hedging and, to a limited extent, income generation transactions.

4. Definitions

- a. "Derivative instrument" [Article I, Section 2 (V)] means an agreement, option, instrument or a series or combination thereof:
 - (1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
 - (2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.
- b. "Derivative instruments" include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof and any agreements, options or instruments permitted under regulations adopted under Section 8. *Id.*
- c. "Derivative transaction" means a transaction involving the use of one or more derivative instruments. [Article I, Section 2 (W)].

5. Substantive provisions permitting life insurers to engage in derivative transactions.

a. General conditions

- (1) Limitations on Hedging Transactions
 - (a) An insurer may use derivative instruments under

Section 18 of the Model Act to engage in hedging transactions and certain income generation transactions, as these terms may be further defined in regulations promulgated by the commissioner.

- (b) An insurer shall be able to demonstrate to the commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analyses.

(2) An insurer may enter into hedging transactions under Section 18 of the Model Act if, as a result of and after giving effect to the transaction :

- (a) The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;
- (b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and
- (c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

(3) **Limitations on Income Generation Transactions**

- (a) An insurer may only enter into the following types of income generation transactions if as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of its admitted assets:
 - i) Sales of covered call options on non-callable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the

noncallable period or derivative instruments based on fixed income securities;

- ii) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;
- iii) Sales of covered puts on investments that the insurer is permitted to acquire under this Act, if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or
- iv) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding.

(4) **Counterparty Exposure**

- (a) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations of Section 10 of the Model Act, which governs diversification standards and certain foreign investments.
- (b) Additional Transactions
 - i) Pursuant to regulations to implement the Model Act which may promulgated under the authority of Section 8, the insurance commissioner may approve additional transactions involving the use of derivative instruments in excess of the limits imposed by Section 8(B) or for other risk management purposes under regulations promulgated by the commissioner, but replication transactions shall not be permitted for other than *risk management* purposes.

(c) Definition: "Counterparty Exposure Amount" means:

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

ii) The amount of credit risk equals:

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

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

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

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

b) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment

by the insurer to the business entity.

a. **Written Agreement and Conditions Required Under the Act**

- (1) The insurer shall enter into a written agreement for all transactions authorized in this section other than dollar roll transactions.
 - (a) "Dollar roll transaction" means two (2) simultaneous transactions with different settlement dates no more than ninety-six (96) days apart, so that in the transaction with the earlier settlement date, an insurer sells to a business entity, and in the other transaction the insurer is obligated to purchase from the same business entity, substantially similar securities of the following types:
 - i) Asset-backed securities issued, assumed or guaranteed by the Government National Mortgage Association, the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their respective successors; and
 - ii) Other asset-backed securities referred to in Section 106 of Title I of the Secondary Mortgage Market Enhancement Act of 1984 (15 U.S.C. s 77r- 1), as amended.
- (2) The written agreement shall require that each transaction terminate no more than one year from its inception or upon the earlier demand of the insurer.
- (3) The agreement shall be with the business entity counterparty.

D. **NAIC Derivative Instruments Model Regulation, NAIC Model Reporting Service, Volume III at 282-1(1996).**

1. This model regulation was adopted together with the NAIC Investments of Insurers Model Act (Defined *Limits* Version).
2. It provides additional guidance and clarification for application of the model law.
3. **Selected provisions**
 - a. Guidelines and Internal Control Procedures are set forth at Section 4

- (1) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:
 - (a) Address investment or, if applicable, underwriting objectives, and risk constraints, such as credit risk limits;
 - (b) Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and
 - (c) Require compliance with internal control procedures.
- (2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective.
- (3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

b. Documentation Requirements are set forth at Section 5

- (1) An insurer shall maintain documentation and records relating to each derivative transaction, such as:
 - (a) The purpose or purposes of the transaction;
 - (b) The assets or liabilities to which the transaction relates;
 - (c) The specific derivative instrument used in the transaction;
 - (d) For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount; and
 - (e) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.
- (2) **Trading Requirements** are set forth at Section 6, which mandates that each derivative instrument shall be:
 - (a) Traded on a qualified exchange;

- (b) Entered into with, or guaranteed by, a business entity;
- (c) Issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or
- (d) Entered into with a qualified foreign exchange.

4. **Overview of the Defined Standards Version of the NAIC Investments of Insurers Model Act**

- a. This Model Act is premised on specific capital standards, and provides a framework in which these standards relate to the investment laws, and established consequences for failure to meet capital standards. To the extent an insurer's investment program is imprudent, the insurer is deemed unsound.
- b. The minimum financial security benchmark and the minimum asset requirement jointly form the foundation for regulating life insurer investments according to a modern portfolio or prudence standard.
 - (1) These twin tools allow a high level of investment discretion above the minimum asset requirement while still providing meaningful regulatory protections for policyholders and claimants from adverse investment management.
 - (2) Section 3 of the Defined Standards Proposal creates limitations and restrictions on investments counted toward the minimum asset requirement; Assets in excess of the minimum asset requirement would not be subject to these limitations and restrictions and may be invested according to the insurer's individual written investment policy.
- c. Three philosophies to capital requirements are central to the Act's approach to regulating investments according to a prudence standard.
 - (1) The Act's "minimum capital" (for stock insurance companies) and "minimum surplus" (for mutual insurance companies) ensure financial stability at the inception of a new insurance enterprise. The amount of capital or surplus needed depends on what types of business the insurer intends to conduct, and are established based on the information the insurer gives the insurance commissioner at the time of formation. See, Annotations to Section 3 of NAIC Investments of Insurers Model Act

(Defined Standards Version) at 17 (1997).

- (2) The "minimum financial security benchmark" measures the minimum capital requirements of an established enterprise, and expand as the financial needs to the enterprise expand, but may also contract with them. *Id.*
 - (3) The "proper surplus" appropriate for a particular company's operation is determined by the insurer's board of directors in consultation with management. *Id.*
- d. The fundamental enforcement mechanism under the defined standards proposal appears in Section 11 which provides that if an insurer does not meet the minimum asset requirement, then under Section 11D, the insurer may be deemed to be in financially hazardous condition, and the commissioner may initiate liquidation and rehabilitation proceedings against the insurer. *Id.* at 21.

(5) Status of Investments of Insurers Model Acts in the States

- (A) A state by state chart follows this section.

INVESTMENTS OF INSURERS MODEL ACT

| STATE | LAWS AND REGULATIONS |
|----------------------|---|
| Alabama | ALA. CODE §§ 27-41-1 to 27-41-41 (1977/1993) (Life). |
| Alaska | ALASKA ADMIN. CODE tit. 3, §§ 21.201 to 21.399 (2001/2005). ALASKA STAT. §§ 21.21.010 to 21.21.420 (1966/2001) (Includes authority to adopt regulations consistent with defined limits version). |
| Arizona | ARIZ. REV. STAT. ANN. §§ 20-531 to 20-561 (1954/2000). |
| Arkansas | ARK. CODE ANN. §§ 23-63-801 TO 23-63-841 (1959/2009). |
| California | CAL. INS. CODE §§ 1170 to 1212 (1935/2009). CAL. CODE REGS. Tit. 10, §§ 2690.90 to 2690.94 (2007); BULLETIN 95-5A (1995). |
| Colorado | COLO. REV. STAT. §§ 10-3-213 to 10-3-242 (1969/2000). |
| Connecticut | CONN. GEN. STAT. §§ 38a-102 to 38a-102i (1991/2009); BULLETIN FS-14c-00 (2000). |
| Delaware | DEL. CODE ANN. Tit. 18, §§ 1301 to 1332 (1953/2002). |
| District of Columbia | D.C. CODE §§ 31-1371.01 to 31-1375.01 (2002). |
| Florida | FLA. STAT. §§ 625.301 to 625.340 (1959/1993). |
| Georgia | GA. CODE ANN. §§ 33-11-50 to 33-11-67 (2000). |
| Guam | GUAM GOV'T. CODE § 43166 (1951). |
| Hawaii | HAW. REV. STAT. §§ 431:6-101 to 431:6-501 (1987/2009); §§431:6-601 to 431:6-602 (1987/2008). |
| Idaho | IDAHO CODE ANN. §§ 41-701 to 41-736 (1961/2006). |
| Illinois | 215 ILL. COMP. STAT. 5/126.1 to 5/126.32 (1997). ILL. ADMIN. CODE tit. 50, §§ 806.10 to 806.60 (1998/2001). Company Bulletin 92-2 (1992). |
| Indiana | IND. CODE §§ 27-1-12-2 to 27-1-12-3.5 (1935/2004) (Life); §§ 27-1-13-3 to 27-1-13-3.5 (1935/2004) (P/C). |
| Iowa | IOWA CODE §§ 511.8 to 511.8A (1868/2000) (Life); § 515.35 (1868/1997) (P/C). IOWA ADMIN. CODE r. 191-93.6; BULLETIN 2008-18 (2008). |

INVESTMENTS OF INSURERS MODEL ACT

| STATE | LAWS AND REGULATIONS |
|----------------|---|
| Kansas | KAN. STAT. ANN. §§ 40-2a01 to 40-2a28 (1972/2005) (P/C); §§ 40-2b01 to 40-2b29 (1972/2005) (Life). |
| Kentucky | KY. REV. STAT. ANN. §§ 304.7-010 to 304.7-473 (2000). |
| Louisiana | LA. REV. STAT. ANN. §§ 22:581 to 22:601 (2007/2010). |
| Maine | ME. REV. STAT. ANN. Tit. 24-A, §§ 1101 to 1137 (1969/2000) (P/C); §§ 1151 to 1161 (1987/2000) (Life). |
| Maryland | MD. CODE ANN., INS §§ 5-501 to 5-512 (1922/2003) (Life); §§ 5-601 to 5-609 (1943/1997) (P/C); MD. ADMIN. CODE CH. 650 §§ 1 to 011 (1998/2008). |
| Massachusetts | MASS. GEN. LAWS. Ch. 175 §§ 63 to 68 (1817/1996). |
| Mississippi | MISS. CODE ANN. §§83-19-51 to 83-19-55 (1892/2010). |
| Missouri | MO. REV. STAT. §§ 375.325 TO 375.355 (1939/2002); §§ 375.532 TO 375.534 (1991/2005) (All insurers); §§ 376.300 to 376.311 (1939/2002) (Life) §§ 376.311, 379.083 (1997/2002); § 375.345 (2002); MO. CODE REGS. ANN. Tit. 20, § 200-12.020 (2009). |
| Montana | MONT. CODE ANN. §§ 33-12-101 to 33-12-312 (1999/2001). |
| Nebraska | NEB. REV. STAT. §§ 44-5101 to 44-5154 (1991/2009). |
| Nevada | NEV. REV. STAT. §§682A.010 to 682A.290 (1971/2003). |
| New Hampshire | N. H. REV. STAT. ANN. §§ 402:27 to 402:29-d (1917/1991) (All insurers); §§ 411-A:37 (1978/1990) (Life). |
| New Jersey | N.J. STAT. ANN. §§ 17:24-1 to 17:24-16 (1902/1995) (P/C); §§ 17B:20-1 to 17B:20-8 (1971/2005) (Life). |
| New Mexico | N.M. STAT. ANN. §§ 59A-9-1 to 59A-9-27 (1984/1988). |
| New York | N.Y. INS. LAW §§ 1401 to 1413 (1984/2008). N.Y. COMP. CODES R. & REGS. Tit. 11, §§ 178.0 to 178.10 (Regulation 168) (2001). |
| North Carolina | N.C. GEN. STAT. §§ 58-7-165 to 58-7-205 (1991/2005). |
| North Dakota | N.D. CENT. CODE §§ 26.1-05-18 to 26.1-05-22 (1983/2001). |

INVESTMENTS OF INSURERS MODEL ACT

| STATE | LAWS AND REGULATIONS |
|----------------|--|
| Ohio | OHIO REV. CODE ANN. §§ 3907.14 to 3907.141; §§ 3925.20 to 3925.21 (1953/2001) (Life); §§ 3925.05 to 3925.06 (1953) (P/C). |
| Oklahoma | OKLA. STAT. tit. 36, §§ 1601 to 1629 (1957/2005). |
| Oregon | OR. REV. STAT. §§ 733.510 to 733.780 (1959/2006). |
| Pennsylvania | 40 PA. STAT. ANN. §§ 504.1 to 506.1 (1986/2004) (Life). |
| Puerto Rico | P. R. LAWS ANN. tit. 26, §§ 648-662 (2003). |
| Rhode Island | R.I. GEN. LAWS §§ 27-11-1 to 27-11-3 (1947/1956); §§ 27-11.1 to 27-11.1-8 (1984/2002). |
| South Carolina | S.C. CODE ANN. §§ 38-12-10 to 38-12-510 (2002). |
| South Dakota | S.D. CODIFIED LAWS §§ 58-27-1 to 58-27-111 (1966/2005); S.D. ADMIN. R. 20:06:26:01 (2005/2008). S.D. ADMIN. R. 20:06:26:01 (1995/2008). |
| Tennessee | TENN. CODE ANN. §§ 56-3-301 to 56-3-409 (1907/1998) (Life); §§ 56-3-401 to 56-3-409 (1979/1984) (P/C). |
| Texas | TEX. INS. CODE ANN. §§ 424.001 to 424.218 (2005/2007). |
| Utah | UTAH CODE ANN. §§ 31A-18-101 to 31A-18-110 (1985/2006). |
| Vermont | VT. STAT. ANN. tit. 8, §§ 3461 to 3472 (1967/2000). |
| Virginia | VA. CODE ANN. §§ 38.2-1400 to 38.2.1447 (1986/2002). |
| Washington | WASH. REV. CODE ANN. §§ 48.13.010 to 48.13.360 (1947/2004). |
| West Virginia | W. VA. CODE §§ 33-8-1 to 33-8-32 (1957/2004). |
| Wisconsin | WIS. STAT. §§ 620.01 to 620.25 (1971/1992). |
| Wyoming | WYO. STAT. ANN. §§ 26-7-101 to 26-7-116 (1967/2001). |



Financial Condition

Examiners Handbook

INTRODUCTION

This Handbook is a guide to assist state insurance departments in conducting risk-focused examinations, as a key component of establishing and operating an effective risk-focused surveillance process. The purposes of a risk-focused surveillance process are (1) to detect as early as possible those insurers with potential financial trouble; (2) to timely identify noncompliance with state statutes and regulations; (3) to compile the information needed for timely, appropriate regulatory action; (4) to provide a clearer methodology for assessing residual risk in each activity under review and to explain how that assessment translates into establishing examination procedures; (5) to allow the assessment of risk management processes in addition to those that result in financial statement line item verifications, for example, the effectiveness of the board of directors and other corporate governance activities, thus providing an introspective look at operations and quality of the risk management processes of the insurer; and (6) to allow for the utilization of examination findings to establish, verify or revise the company's priority score determined through the department's analysis and utilization of the NAIC tools (e.g., Scoring System, ATS results, IRIS ratios). These elements allow for examinations that emphasize the analysis of an insurer's current or prospective solvency risk areas as well as the fair presentation of surplus. To conduct an effective risk-focused examination, examiners must have adequate training and experience and appropriately involve key regulatory functions in the department, to assist in exercising sound judgment at every stage of the examination process. Enhanced risk assessment is not intended to add additional hours to the examination process, but to assist the examination teams in better allocating their hours to the most critical risks facing the companies they regulate.

The concepts presented in this Handbook can be applied to all examinations; however, modifications may be warranted based upon the nature and size of specific entities. Risk-focused examinations allow flexibility for procedures to be added, modified, supplemented or reduced, in accordance with the overall risk assessment of the insurer. The NAIC acknowledges that considerable judgment will be required of the examiner in completing risk assessments.

History of Risk Assessment and Process of Conducting Examinations

In 2004, the NAIC Risk Assessment Working Group adopted the Risk-Focused Surveillance Framework, whose principles set the foundation for the enhancement of the risk assessment components of this Handbook. Although editions of the Handbook prior to 2007 already utilized a risk-focused approach, that approach focused only on financial reporting issues and audit risk. A broader, organization-wide business risk assessment including strategic and operational issues enhances the process for evaluating the entire solvency risks inherent in an insurer's operations. The enhancement in the risk assessment process and supporting tools will also improve the ongoing surveillance of the insurer. The risk-focused surveillance process includes a formal system for identifying risk, processes for assessing and documenting that risk, and recommendations for how the assessment can be applied in the examination process and to the ongoing monitoring of the insurer.

The revised risk-focused surveillance process was developed by the NAIC in response to a recommendation by the Risk Assessment Working Group. The recommendation was based on the need to enhance the qualitative aspects of examination and financial analysis functions. These enhancements will allow the financial solvency surveillance process to better incorporate prospective risk assessment in identifying insurers that have or will encounter solvency issues and bring focus to the broader issue of the ability of management to identify, assess and manage the business risks of the insurer. These enhancements are considered to be directly aligned with the NAIC Solvency Initiatives.

Historically, many solvency problems have been caused by inadequate management oversight. Inadequate management oversight typically results in inaccurate financial reporting which can prevent the regulator from taking timely remedial or regulatory actions and thus reduces the options available for corrective steps. Solvency issues generally result from business risks that were not mitigated to an acceptable level by company controls. Inadequately controlled operating risks may take several years to be reflected in the company's financial statements.

The Risk Assessment Working Group has determined solvency surveillance needs a broader risk focus to become more proactive in identifying emerging solvency issues. As the revised approach is implemented by state insurance departments, examination activities will be enhanced by a risk-focused methodology that:

- More clearly directs financial statement verification to only those key accounts and control objectives of those accounts with the greatest risk, and
- Directs the examination focus to the identification of significant strategic and operating risks, investigation of mitigation strategies for those risks, and recommendations for enhancements where appropriate to reduce residual risks to a more acceptable level.

B. Overview of Risk-Focused Surveillance Process

The intent of the risk-focused surveillance process is to broaden and enhance the identification of risk inherent in an insurer's operations and utilize that evaluation in formulating the ongoing surveillance of the insurer. This assessment could be completed on a legal entity basis or on an organization-wide basis depending on how the company structures its business. Through their activities, insurers assume a variety of risks, which is the essence of an insurance transaction. The type of risk and its significance varies by activity. Investment activities may involve credit risk, market risk and liquidity risk. In product sales, insurers may assume market risk, pricing/underwriting risk, strategic risk or liquidity risk in varying degrees, depending on the product. Over the years, state insurance regulators have developed numerous tools to address the risks insurers assume. Investment laws limit the market and credit risk insurers can assume. Limitations on net retentions help reduce catastrophe risk. Risk-based capital requirements establish capital levels in recognition of a variety of risks. Insurance regulators have always considered the risk profiles of licensed insurers and the activities that may pose risk to the company in the future. The risk-focused surveillance process utilizes an organization-wide risk assessment process to enhance evaluation and to better coordinate the activities of financial solvency surveillance through greater consistency within the department, and with other departments.

A risk-focused surveillance process includes identifying significant risks, assessing and analyzing those risks, documenting the results of the analysis, and developing recommendations for how the analysis can be applied to the ongoing monitoring of the insurer. This increased attention by regulators to risk assessment and risk management processes utilized by insurers will be a positive development.

The enhancements included in the risk-focused surveillance process intend to provide the following benefits:

1. Strengthen regulatory understanding of the insurer's corporate governance function by documenting the composition of the insurer's board of directors and the executive management team as well as the quality of guidance and oversight provided by the board and management.
2. Enhance evaluation of risks through assessment of inherent risks and risk management processes regarding weaknesses of management's ability to identify, assess and manage risk.
3. Improve early identification of emerging risks at individual insurers on a sector-wide basis.
4. Enhance effective use of regulatory resources through increased focus on higher risk areas.
5. Increase regulatory understanding of the insurer's quality of management, the characteristics of the insurer's business and the risks it assumes.
6. Enhance the value of surveillance work and establishment of risk assessment benchmarks performed by insurers and regulators, who have common interest in ensuring that risks are properly identified and that adequate, effective control systems are established to monitor and control risks.
7. Better formalize and document the risk assessment process via the use of the risk assessment matrix tool to assist in examination planning and resource assignment.
8. Expand risk assessment to provide a more comprehensive and prospective look at an insurer's risks through identification of the insurer's current and/or prospective high-risk areas.

Coordinate the results of the risk-focused examination process with other financial solvency surveillance functions (i.e., establishing/updating the priority score and supervisory plan).

In full, the risk-focused surveillance process provides effective procedures to monitor and assess the solvency of insurers on a continuing basis. The risk-focused surveillance process is embedded in the planning activities and throughout each phase of the risk-focused surveillance process discussed in detail within this Handbook. The revised approach consists of a structured methodology designed to establish a forward-looking view of an insurer's risk profile and the quality of its risk management practices. This approach permits a direct and specific focus on the areas of greatest risk to an insurer. Through this approach, state insurance regulators can be more proactive and better positioned to identify and respond to any serious threat to the stability of the insurance company from any current or emerging risks. This regulatory approach will benefit all participants in the insurance marketplace.

C. Risk-Focused Surveillance Cycle

The system of financial surveillance advocated by the Risk-Focused Surveillance Framework is designed to provide continuous regulatory oversight. The risk-focused approach requires fully coordinated efforts between the financial examination function and the financial analysis function. There should be a continuous exchange of information between the field examination function and the financial analysis function to ensure that all members of the department are properly informed of solvency issues related to the state's domestic insurers.

Responsibilities of the analysts in the Risk-Focused Financial Surveillance Framework are (1) to monitor the states' domestic insurers; (2) to provide updates to the Insurer's Profile Summary; (3) to provide input for the department's priority score for each insurer; and (4) to provide department management with timely knowledge of significant events relating to the domestic insurers. This information is used by the field examination function as input for scheduling and staffing of examinations. In anticipation of a field examination, the examiners and analysts should conduct a planning meeting to facilitate the exchange of relevant information between the analyst and the examination team. As the examiners conduct the financial examinations, they should inform the analyst of any significant examination findings. At the conclusion of the on-site examination, the examiners and analysts should work together to determine the company's priority score. The development of the management letter to the company should include contributions from the examiners and analysts. It is strongly recommended that the analyst be responsible for evaluating and following-up with the company responses to the management letter comments, as after the report of the examination has been issued, the analyst will be the primary regulatory contact with the company until the next examination.

The regulatory Risk-Focused Surveillance Cycle involves five functions, most of which are performed under the current financial solvency oversight role. The enhancements coordinate all of these functions in a more integrated manner that should be consistently applied by state regulators. The five functions of the risk assessment process are illustrated within the Risk-Focused Surveillance Cycle.

As illustrated in the Risk-Focused Surveillance Cycle diagram, elements from the five identified functions contribute to the development of an Insurer Profile Summary. Each state will maintain an Insurer Profile Summary for their domestic companies. Regulators that wish to review an Insurer Profile Summary for a non-domestic company will be able to request the Insurer Profile Summary from the domestic or lead state. The documentation contained in the Insurer Profile Summary is considered proprietary, confidential information that is not intended to be distributed to individuals other than state regulators.

Please note that once the Risk-Focused Surveillance Cycle has begun, any of the inputs to the Insurer Profile Summary can be changed at any time to reflect the changing environment of an insurer's operation and financial condition.

EXAMINATION REPOSITORY - INVESTMENTS

Annual Statement Blank Line Items

Listed below are the corresponding Annual Statement line items that are related to the identified risks contained in this exam repository:

Bonds
Stocks (Preferred and Common)
Mortgage Loans on Real Estate
Cash, Cash Equivalents and Short-Term Investments
Contract Loans
Derivatives
Receivables for Securities
Payable for Securities
Investment Income Due and Accrued (*P&C Companies*)
Other Invested Assets
Securities Lending – Reinvested Collateral Assets
Miscellaneous Liabilities – Asset Valuation Reserve
Contract Liabilities Not Included Elsewhere – Interest Maintenance Reserve

Other Annual Statement line items related to investments, whose risks are less common, have not been included in this examination repository. They include the following:

Real Estate
Aggregate Write-Ins for Invested Assets
Drafts Outstanding
Unearned Investment Income (*Life Companies*)
Liability for Deposit-Type Contracts (*Life Companies*)
Contract Liabilities Not Included Elsewhere – Surrender Values on Cancelled Contracts (*Life Companies*)

Relevant Statements of Statutory Accounting Principles (SSAPs)

All of the relevant SSAPs related to the investment process, regardless of whether or not the corresponding risks are included within this exam repository, are listed below:

No. 2 Cash, Drafts and Short Term Investments
No. 7 Asset Valuation Reserve and Interest Maintenance Reserve
No. 21 Other Admitted Assets
No. 23 Foreign Currency Transactions and Translations
No. 26 Bonds, excluding Loan-backed and Structured Securities
No. 30 Investments in Common Stock
No. 32 Investments in Preferred Stock
No. 34 Investment Income Due and Accrued
No. 37 Mortgage Loans
No. 38 Acquisition, Development, and Construction Arrangements
No. 39 Reverse Mortgages
No. 40 Real Estate Investments
No. 41 Surplus Notes
No. 43R Loan-backed and Structured Securities—Revised
No. 44 Capitalization of Interest
No. 48 Investments in Joint Ventures, Partnerships and Limited Liability Companies
No. 49 Policy Loans

- No. 56 Separate Accounts
- No. 74 Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Sale
- No. 77 Real Estate Sales
- No. 83 Mezzanine Real Estate Loans
- No. 86 Accounting for Derivative Instruments and Hedging Activities
- No. 90 Accounting for the Impairment or Disposal of Real Estate Investments
- No. 91R Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Revised
- No. 93 Accounting for Low Income Housing Tax Credit Property Investments

| Sub-Activity | Identified Risk | Branded Risk | Exam Asrt. | Control Best Practices | Possible Test of Controls | Possible Detail Tests |
|--------------|--|----------------------|------------|--|---|--|
| | | | | | management framework. | has been performed by an investment specialist, review the results and perform necessary follow-up procedures. |
| N/A | The insurer is not properly implementing and monitoring derivative transactions. | MK CR ST OP | Other | <p>The insurer has properly adopted a derivative use plan within the investment policy approved by the board of directors, which includes the following attributes:</p> <ul style="list-style-type: none"> • Management controls • Type and use limits • Relationship to overall investment limits • Documentation and reporting requirements • Valuation procedures • Quantitative limits • Risk management standards • Compliance with state law, internal policy and NAIC practices. <p>The insurer frequently reviews its derivative position to determine effectiveness of hedging and replication transactions and adjusts</p> | <p>Review how management ensures that its derivative use plan is complete and in compliance with applicable laws and best practices.</p> <p>Determine whether the insurer's derivative traders are part of its larger risk-management organization and not a profit center.</p> <p>Determine whether the company effectively implements its derivative strategy by performing a walk through with investment staff. Inquire as to how they ensure that derivative agreements are in-line with the strategy and objectives of the insurer.</p> <p>Review management control procedures for determining effectiveness of hedging and replication transactions for adequacy.</p> | <p>Review the insurer's derivative use policy guidelines for appropriateness.</p> <p>Perform a review of the insurer's derivative position to ensure it is in compliance with the hedging and replication strategies outlined in the derivative use plan.</p> <p>Select a sample of derivatives and review the following attributes for compliance with its plan:</p> <ul style="list-style-type: none"> • Valuation • Effectiveness • Legal review • Accounting compliance • Maturity reasonableness (i.e., not long dated) <p>Review hedge performance for periods of market volatility.</p> <p>If a portfolio analysis has been performed by</p> |

| Sub-Activity | Identified Risk | Branded Risk | Exam Asrt. | Control Best Practices | Possible Test of Controls | Possible Detail Tests |
|--------------|--|----------------------|------------|--|--|---|
| | | | | where necessary. | | an investment specialist, review the results and perform necessary follow-up procedures. |
| N/A | The insurer is not properly implementing and monitoring security lending, repurchase and reverse repurchase transactions | MK CR ST OP | Other | <p>Insurer management implements controls over credit, market, and operational risk associated with lending securities, which include monitoring the following:</p> <ul style="list-style-type: none"> • Percent and type of securities permitted to be loaned • Borrower concentration and credit worthiness • Amount of collateral and systematic true-up • Investment of cash collateral <p>The insurer has established a securities lending framework based on its tolerance for market risks (including market price volatility, securities lending and interest rate risks) and has included guidelines as to the internal approvals required to approve agreements, counterparty balances, programs and strategies.</p> | <p>Review management's lending program and methods to compare it to actual operations.</p> <p>Determine how management ensures that the lending program complies with state laws, regulation, internal policy and NAIC practices.</p> <p>Review management controls to ensure that inordinate amounts of leverage and exposure to duration/liquidity risks are not created through reinvestment of collateral.</p> <p>Evaluate the following internal procedures for adequacy:</p> <ul style="list-style-type: none"> • Internal approvals • Regulatory framework • Contractual agreements • Counterparty management • Program size and composition • Lending strategies | <p>Review guidelines for any securities lending programs deemed off-balance sheet.</p> <p>Review duration of reinvested collateral in relation to lending agreements and potential liquidity shortfalls.</p> <p>Compare the maturity dates of the reinvested collateral in Schedule DL to the term of the lending agreement to determine whether there is any mismatch in the maturity considering the duration of when the lent securities and cash collateral are expected to be returned per contract.</p> |



National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

For more information, visit www.naic.org



