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March 15, 2013

Re: Margin Requirements for Non-Centrally Cleared Derivatives: BCBS-IOSCO Second Consultative Document (February 2013)

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. Many of our members also provide life insurance, annuity and employee benefit programs on a global basis. 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”). Life insurers use derivatives to responsibly manage asset and liability risks.

ACLI submitted comments on the initial BCBS-IOSCO Consultative Document¹. The Second Consultative Document² and its “near-final” positions constructively comport with the views in our submission. We strongly support the inclusion of the types of highly liquid collateral in the illustrative list as a baseline for collateral eligible to be pledged as margin and also support the ability of national regulators to expand the scope of eligible collateral and the continued focus on the impact of margin requirements on liquidity. ACLI concurs with the Consultative Documents’ endorsement of universal two-way variation margining and a flexible approach with respect to initial margin requirements for Swap Dealers and Major Swap Participants to mitigate the impact on liquidity.

¹ Submission on Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives, published by the Basel Committee on Bank Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) (May 2012) (“BCBS-IOSCO Consultative Paper”) [<http://www.bis.org/publ/bcbs226/acoli.pdf>] [BCBS-IOSCO].

² BCBS-IOSCO Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (Feb. 2013) (“Second BCBS-IOSCO Consultative Paper”) [<http://www.bis.org/publ/bcbs242.pdf>]

ACLI also submitted detailed comments on parallel regulatory proposals developed by U.S. prudential regulators, the U.S. Commodity Futures Trading Commission (“CFTC”), and the U.S. Securities and Exchange Commission (“SEC”).³ These concomitant proposals represent multiple moving parts in a multi-layered regulatory system that will directly affect life insurers on a global basis.

We strongly encourage coordinated domestic and international approaches to derivatives regulation that will ensure cost-effective, harmonized regulation and prevent regulatory arbitrage. Regulations governing margin requirements for non-centrally cleared derivatives transactions should be conceptually uniform to minimize or eliminate unnecessary and costly differences that could thwart enterprise-wide compliance procedures and greatly increase systems costs. Because many aspects of the Second Consultative Document endeavor to establish harmonized international standards governing derivatives transactions, we greatly appreciate the opportunity to share the views of the life insurance industry on these important matters.

Our submission provides background on life insurers’ participation in the derivatives markets, addresses the “near-final” standards in the Second Consultative Document, and responds to the specific questions on remaining open issues in the document.

I. Background: Life Insurers’ Use of Derivatives to Manage Asset and Liability Risks

A brief explanation on the regulation and use of derivatives by life insurers provides useful context for our comments below and helps explain why the regulatory status of derivatives is vitally important to the life insurance industry.⁴

³ See, e.g. ACLI submissions on:

- Supplemental Request for Comments on Proposed Margin and Capital Requirements for Covered Swap Entities; [http://www.fhfa.gov/webfiles/24691/95_American%20Council%20of%20Life%20Insurers%20ACLI.pdf] [five prudential regulators];
- Supplemental Request for Comments on Proposed Margin Requirements Governing Uncleared Swap Transactions for Swap Dealers and Major Swap Participants [<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58806&SearchText=wilkerson>] [CFTC];
- CFTC Proposal on Protection of Cleared Swaps Customer Contracts and Collateral [<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48045&SearchText=wilkerson>] [CFTC]; and,
- SEC proposal on margin, capital and segregation for security-based swap dealers and major security-based swap participants [<http://www.sec.gov/comments/s7-08-12/s70812-25.pdf>].

⁴ Because 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. 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 security 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.

Insurers use a diverse group of financial derivatives, from standardized derivatives, such as 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 an important 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.⁵ 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 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 carefully regulated under state insurance laws and regulations that 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.⁶

⁵ Restrictions 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.

⁶ 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

II. Comments on “Near-Final” Standards in the Consultative Documents

A. Impact of Margin Requirements on Liquidity

The Consultative Documents state 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 documents note that financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. Moreover, the documents observe that liquidity impact of margin requirements cannot be considered in isolation.

As a general matter, the Consultative Documents emphasize that all derivatives not centrally-cleared by a central clearing party (CCP) should be subject to margining requirements. In principle, the documents indicate 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.⁷

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.

⁷ The Consultative Documents establish “near-final” standards for margin requirements for non-centrally-cleared derivatives through key principles addressing eight main elements:

1. Appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.
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.
8. Margin requirements should be phased-in over an appropriate period of time to ensure that the transition costs associated with the new framework can be appropriately managed. Regulators should undertake a coordinated

We fully agree with the Consultative Documents' 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.⁸

The Consultative Documents' 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 Second Consultative Document recommends permitting a broader set of eligible collateral, including assets like liquid corporate bonds and equity securities, and addresses the potential volatility of such assets through application of appropriate haircuts to their valuation for margin purposes. The Consultative Document constructively observes that this 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.

ACLI fully supports the Consultative Documents' recommendation to broadly define collateral eligible for margin. This recommendation is largely consistent with a parallel suggestion ACLI presented to U.S. regulators on eligible collateral for margin.⁹

review of the margin standards once the requirements are in place and functioning to assess the overall efficacy of the standards and to ensure harmonisation across national jurisdictions as well as across related regulatory initiatives.

⁸ 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. Treasury 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.

⁹ 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

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 Documents' approach allowing broader categories of eligible collateral.

C. Proposed Examples of Eligible Collateral

As a guide, the Consultative Documents denote the following examples of recommended eligible collateral:

- 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 Documents note 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

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.

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 Documents 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 Documents' key principle, and should be evaluated by regulators as eligible collateral. A broad range of eligible high-quality collateral, with appropriate haircuts, will prudently assure satisfaction of counterparty obligations while also enhancing liquidity in the market and reducing systemic risk.¹⁰

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 Documents explain that these assets should be highly liquid and should, after accounting for an appropriate haircut, maintain their value in a time of financial stress.¹¹ The Consultative Documents 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.

We support the concepts in the Consultative Documents 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.

We respectfully suggest a clarification of Requirement 3.4 in the Second Consultative Document that initial margin for purchased options and credit default swaps that are not fully paid for at inception should be limited to the present value of the outstanding premium to be paid. This approach reflects a logical extension of the rationale in Requirement 3.4 that for derivatives transactions where a firm faces no counterparty risk, collection of initial margin should not be required.

¹⁰ The Standardised Haircut in Appendix B suggests an "additional (additive) haircut on assets in which the currency of the derivative obligation differs from that of the collateral asset" equaling 8% of the market value. Given that the permitted asset classes in the Consultative Documents are high quality instruments with low volatility, the 8% adjustment seems a bit high. We suggest, therefore, a lower additive haircut in the range of 4-5% for supplemental currency rate haircuts.

¹¹ 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").

E. Consultative Document Commentary on Margin Standards Across Jurisdictions

The Consultative Documents state 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 Documents that the scope of eligible collateral should be kept broad, with appropriate haircuts and recommends that

F. Universal Two-way Margin Requirements

The Second Consultative Document supports universal two-way margining, noting that

With respect to other non-centrally cleared derivatives, the BCBS and IOSCO support margin requirements that, in principle, would involve the mandatory exchange of both initial and variation margins among parties to non-centrally cleared derivatives ("universal two-way margin").

Although supportive of universal two-way margining concepts, ACLI recommends 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 expected volatility of the trade, product type or creditworthiness of the swap dealer, 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.

III. Responses to Specific Questions Posed in the Second Consultative Document

Question 1: *Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?*

Response to Question 1: Physically-settled FX forwards and swaps should be exempt from the requirements of initial margin in the case of short-dated swaps, where the risk is minimal.

Question 2: *Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.*

Response to Question 2: Prohibition of rehypothecation may have unintended consequences when combined with mandatory two-way margin requirements. Together, these requirements could reduce dealer liquidity when the financial system requires it most. These two provisions should be viewed together, with market participants having the flexibility to agree to choose the level of protection for initial or variation margin pledged to swap dealers which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over initial or variation margin. The BCBS-IOSCO proposal to allow rehypothecation under strict customer protection provisions is positive, however it should be noted that a party that agrees to receive rehypothecated

collateral (Party C) may not be willing to accept it if there is a priority lien over it held by the initial posting party (Party A). There are also questions regarding whether Party A would be able to perfect the lien and enforce upon it (particularly where the collateral posted is cash) when the collateral is held by Party C.

Question 3: *Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk? Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?*

Response to Question 3: The proposed phase-in periods are appropriate and represent logical balancing of systemic risk considerations with liquidity, operational and transitional factors associated with implementing the recommendations in the Consultative Document. Because the near-final proposal would only apply the requirements to new transactions, the margin would be posted gradually over time as new transactions replace old ones. The phase-in periods allow for responsible synchronization with numerous concurrent regulatory initiatives. We agree that regulators should undertake a coordinated review of the margin standards once the requirements are in place and functioning to assess the overall efficacy of the standards and to ensure harmonization across national jurisdictions.

Question 4: *BCBS-IOSCO seek comment on the accuracy and applicability of the Quantitative Impact Study (QIS) results.*

Response to Question 4: The conclusions of the QIS rely considerably on the ability of market participants to adopt internal models for the purposes of calculating initial margin requirements. This introduces practical considerations. First, the proposed rules require margin models to be approved by the appropriate regulatory body. Unless a standardized model is approved, the relevant regulatory bodies will spend significant time reviewing and approving margin models for each market participant who chooses to use one. Second, lack of an approved standardized model will give rise to increases in margin disputes as an outgrowth of universal two way margining. Third, lack of consistency among swap dealer models will inhibit the ability of financial end-users to novate trades between counterparties. In the event of a novation, the original swap dealer may need to post additional initial margin to the swap dealer entering into the trade. This subjective, increased cost will likely be passed on to financial end-users. This will decrease liquidity and price transparency in this market.

While we fully appreciate the demanding time constraints and complexity in conducting the QIS, the survey participants may not be representative of all types of financial institutions. The QIS survey results can be enhanced by eliciting a broader range of market participants' input. For example, if more life insurers were represented in the survey, the results would reflect a broader range of instruments, and longer durations.

Additionally, we observe that several numerical benchmarks occur in the Second Consultative Document, such as the two-way universal threshold regimes in Table 5 of the QIS, that are denominated in euros for discussion purposes. We expect that the numerical reference points in the document will be converted to each regulatory regime's relevant local currency when conforming regulations are implemented. For example, we anticipate that the SEC, CFTC and U.S. prudential regulators will implement regulations consonant with the Second Consultative Document in U. S. dollars. This approach will avoid the unnecessary logistical and system burdens of having to frequently recalculate numerical benchmarks as other jurisdictions' currency rates fluctuate.

IV. Conclusion

ACLI supports harmonized international standards for initial and variation margin in non-cleared swaps transactions.¹² We strongly support the key concepts in the Consultative Documents, including enlarging the scope of eligible collateral and focusing on the impact of margin requirements on liquidity. ACLI concurs with the Consultative Documents' strong support for universal two-way variation margining and a flexible approach with respect to initial margin requirements for swap dealers and major swap participants to mitigate the impact on liquidity. All of these matters will lower the risk of financial entities, promote global harmonization, and prevent regulatory arbitrage.

We support alignment of margin requirements for non-cleared swaps globally, especially between major market jurisdictions. The phase-in periods described in the Second Consultative Document will allow orderly transition to the new standards and reflect a rational balancing of systemic risk considerations with expected liquidity, operational and transitional factors. Mandatory two-way margin requirements should be considered together with constraints on rehypothecation to balance

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.

liquidity considerations during periods of market stress. Physically-settled FX forwards and swaps should be exempt from the requirements of initial margin in the case of short-dated swaps, where the risk is minimal

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

Sincerely,

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

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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).



Examiners Handbook



National Association of Insurance Commissioners

Financial Condition

	Exam Obj.	Identified Risk	Examiner/ Completion Date	Work Paper Ref.
15. Scan the cash receipts/disbursements journal and bank statements for unusual debits or credits.	CO AC			
16. Test whether account balances and disclosures comply with the NAIC <i>Accounting Practices and Procedures Manual</i> and <i>Annual Statement Instructions</i> .	PD			
17. Review the Notes to the Financial Statements and General Interrogatories and evaluate the completeness of information.	PD			
18. Consider the reasonableness of accrued interest and interest received during the year based on prior years.	VA			
19. Select a sample of interest payments included on the bank statements. Trace those amounts to the cash receipts journal.	CO AC			
20. Trace the total accrued interest to the detailed investment income exhibit and balance sheet.	CO AC			
21. Trace the total interest received to the detailed investment income exhibit.	CO AC			
22. Ensure that the net amounts of all cash accounts are reported jointly. If in the aggregate the insurer has a net negative cash balance, ensure that the amount is reported as a negative asset and not recorded as a liability, in accordance with SSAP No. 2, paragraph 5.	AC VA			
Aggregate Write-ins for Invested Assets / Liabilities (Derivative Instruments)				
1. Review available independent audit reports and management letters for evidence of inappropriate hedge accounting practices.	AC			
2. Obtain contracts that the insurer has entered into and agree them to the documentation provided in the insurer's records and Schedule DB.	EX OB/OW			

Elements of NAIC Financial Examiners Handbook Regarding Derivatives Start Here

[illegible]

3. Obtain direct confirmation of all derivative instruments held at a custodian or a broker.
4. Review hedging transactions to determine whether they are consistent with the category hedged, in accordance with SSAP No. 86, paragraph 18:
 - a. Fair value hedges (SSAP 86, paragraph 19);
 - b. Cash flow hedges (SSAP 86, paragraph 20);
 - c. Forecasted Transaction Hedges (SSAP 86, paragraph 21);
 - d. Foreign currency hedges (SSAP 86, paragraph 22-31).
5. Determine whether the appropriate accounting method was applied based on the type of derivative (e.g., swaps, options, forwards, etc.), in accordance with SSAP No. 86.
6. Review the hedging transactions to determine that ineffective hedges have been accounted for at fair value with changes in the fair value recorded as an unrealized gain/loss in accordance with SSAP 86, paragraph 15.
7. Select a sample of market values from Schedule DB and verify compliance with the guidelines set forth in SSAP No. 86 and the *Purposes and Procedures Manual* of the NAIC SVO.
8. Review the state investment statutes related to derivative instruments for compliance.

Exam Obj.	Identified Risk	Examiner Completion Date	Paper Ref.
EX OB/OW			
VA			
VA			
VA			
VA			
VA			
VA			
VA PD			
VA			
VA			

	Exam Obj.	Identified Risk	Examiner/ Completion Date	Work Paper Ref.
9.	Verify that the insurer has properly documented derivative instruments opened during the year, derivative instruments terminated, expired or exercised during the year and derivative instruments open at quarter-end in accordance with SSAP No. 86, paragraphs 34-36.	PD		
10.	Select a sample of transactions and test whether all significant terms (e.g., maturity, expiration or settlement date, contractual payments, purchase and sale price) were specified and documented, and whether the amounts and terms are consistent with those established by the insurer's hedging techniques.	CO AC		
11.	Select a sample of values from Schedule DB and trace to appropriate source documents.	CO AC		
12.	Test transactions settled after year-end for recording in the proper period.	CT		
13.	Verify that disclosure requirements for derivative contracts in accordance with SSAP 86, paragraph 53 have been met.	PD		
<u>Other Invested Assets</u>				
1.	Review investment committee minutes and determine whether investment transactions have been properly authorized.	EX		
2.	Review available independent audit reports and management letters for joint ventures, partnerships and limited liability companies in which the insurer has an interest.	AC		
3.	Make inquiries to ascertain any conflicts of interest or improprieties affecting the directors, officers or employees of the company. (Review conflict of interest statements.)	CM		

SCHEDULE DB

DERIVATIVE INSTRUMENTS

All derivatives, regardless of maturity date, are to be reported on Schedule DB. Forward commitments where a Company cannot determine at the inception of the contract, with certainty, if delivery will be made at the earliest opportunity are essentially forward contracts and should be reported on Schedule DB.

This schedule should be used to report derivative instruments (including insurance futures and options on insurance futures). Specific accounting procedures for each derivative instrument will depend on the definition below and documented intent that best describes the instrument. Uses of derivative instruments that are reported in this schedule include hedging, income generation and other. State investment laws and regulations should be consulted for applicable limitations and permissibility on the use of derivative instruments. If the derivative strategy meets the definition of hedging as outlined in paragraph 7 of SSAP No. 86, Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions, then the underlying derivative transactions composing that strategy should be reported in that category of Schedule DB. If the underlying derivative strategy does not meet the definition of hedging, then the underlying derivative transactions composing that strategy should be reported as either income generation or other.

DEFINITIONS OF DERIVATIVE INSTRUMENTS

A hedge transaction is “Anticipatory” if it relates to:

- a. A firm commitment to purchase assets or incur liabilities, or
- b. An expectation (but not obligation) to purchase assets or incur liabilities in the normal course of business.

“*Underlying Interest*” means the asset(s), liability(ies), or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments, or other financial market instruments.

“*Option*” means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, level, performance, or value of, one or more Underlying Interests.

“*Cap*” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance, or value of one or more Underlying Interests exceed a predetermined number, sometimes called the strike/cap rate or price.

“*Floor*” means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price exceeds a reference price, level, performance or value of one or more Underlying Interests.

“*Collar*” means an agreement to receive payments as the buyer of an Option, Cap or Floor and to make payments as the seller of a different Option, Cap or Floor.

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

“*Forward*” means an agreement (other than a Future) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of, one or more Underlying Interests.

“*Future*” means an agreement traded on an exchange, Board of Trade, or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value, one or more Underlying Interests.

“Insurance Futures Contract” means a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto, or such other definition as may be specified under the statutes, regulations and administrative rulings of a particular state.

“Insurance Futures Option” means a put or call option on an Insurance Futures contract.

“Insurance Futures Call Option” means a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date.

“Insurance Futures Put Option” means a contract under which the holder has the right to sell the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date.

“Option Premium” means the consideration paid (received) for the purchase (sale) of an Insurance Future Option.

“Margin Deposit” means a deposit that an insurer is required to maintain with a broker with respect to the underlying Insurance Futures Contracts purchased.

GENERAL INSTRUCTIONS FOR SCHEDULE DB

Each derivative instrument should be reported in Parts A, B, C, or D according to the nature of the instrument, as follows:

Part A: Options*, Caps, Floors and Insurance Futures Options Owned

Part B: Options*, Caps, Floors and Insurance Futures Options Written

Part C: Collars, Swaps and Forwards**

Part D: Futures Contracts and Insurance Futures Contracts Open

* Warrants acquired in conjunction with public or private debt or equity that are more appropriately reported in other schedules do not have to be reported in Schedule DB.

** Forward commitments that are not derivative instruments (for example, the commitment to purchase a GNMA security two months after the commitment date, or a private placement six months after the commitment date) should be disclosed in the Notes to Financial Statements rather than on Schedule DB.

Part E should be used to report the counterparty exposure, (i.e., the exposure to credit risk on derivative instruments) to each counterparty (or guarantor as appropriate).

SCHEDULE DB – PART A
SECTIONS 1, 2, AND 3

GENERAL INSTRUCTIONS

In each Section, separate derivative instruments into the following categories:

<u>Category</u>	<u>Line Number</u>
Call Options:	
Hedging	0199999
Other	0399999
Subtotal – Call Options	0499999
Put Options:	
Hedging	0599999
Other	0799999
Subtotal – Put Options	0899999
Caps:	
Hedging	0999999
Other	1199999
Subtotal – Caps	1299999
Floors:	
Hedging	1399999
Other	1599999
Subtotal – Floors	1699999
Insurance Futures Call Options:	
Hedging	1799999
Other	1999999
Subtotal – Insurance Futures Call Options	2099999
Insurance Futures Put Options	
Hedging	2199999
Other	2399999
Subtotal – Insurance Futures Put Options	2499999
Totals:	
Subtotal – Hedging	2599999
Subtotal – Other	2799999
Total	9999999

Column 1 – Description

Give a complete and accurate description of the derivative instrument, including description of underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.

Column 2 – Number of Contracts or Notional Amount

Where instrument positions are traded based on number of contracts, such as exchange traded options, show the number of contracts. For other instruments, such as caps and floors, show the notional amount (i.e., the amount upon which the next cash payment is based). Notional amount should be based on current U.S. equivalent of the amount receivable from the counterparty as of the (purchase/sale/reporting) date.

Column 3	–	Date of Maturity, Expiry or Settlement
		Show the date of maturity, expiry, or settlement, as appropriate.
Column 4	–	Strike Price, Rate or Index
		Show the strike price, rate, or index for which an option could be exercised or which would trigger a cash payment on a cap or floor. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$).
Column 5	–	Date of Acquisition
		Show the date of the original transaction. The reporting entity may summarize on one line all identical derivative instruments with the same exchange or counterparty showing the date of last acquisition, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
Column 6	–	Exchange or Counterparty
		If exchange traded, show the name of the exchange, Board of Trade, or contract market. If OTC traded, show the counterparty or guarantor upon whose credit the insurer relies.
Column 7	–	Cost/Option Premium
		Indicate the cost of the instrument purchased. For insurance futures, indicate the consideration paid for the purchase of the instrument.

SCHEDULE DB – PART A – SECTION 1

OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS OWNED
DECEMBER 31 OF CURRENT YEAR

Column 8 – Book Value

Book value is the sum of cost plus cumulative increase (decrease) by adjustment in book value.

Column 9 – * Column

Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.

Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.

Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

Column 10 – Statement Value

Instruments shall be valued as follows, providing the transaction is permitted by law or regulations of an insurer’s state of domicile:

a. For Hedges of Items Carried at Amortized Cost

(i) Value at amortized cost, (or alternatively at cost if less than one year maturity).

(ii) If during the life of the instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the instrument shall be valued at current market value (marked to market).

b. For Hedges of Items Carried at Market Value

Value at current market price (marked to market).

c. For Hedges Adjusting the Basis of the Hedged Item

The book value of an instrument may be used to adjust the basis of the hedged item directly. In this case the statement value of the instrument would be zero.

d. For Other Derivative Transactions

Value at current market price (marked to market).

e. For Insurance Options

Column 11	–	Fair Value
		Fair value can be obtained from any one of five sources:
		<ul style="list-style-type: none"> a. Public Market Quotes b. Fair Value Provided by Broker c. Management Estimate d. Pricing Service e. Pricing Matrix
Column 12	–	Increase (Decrease) by Adjustment
		This represents the current year's amortization of the initial cost. For insurance futures options, this represents the current year's increase or decrease in the market value.
Column 13	–	Used to Adjust Basis of Hedged Item
		This represents the amortized book value used to adjust the basis of the hedged item(s) during the current year.
Column 14	–	Other Investment/Miscellaneous Income
		Include current year earned income on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued). For insurance futures options, this represents any increase or decrease (in the value of the instruments) that corresponds to incurred losses for the current reporting period.

SCHEDULE DB – PART A – SECTION 3

**OWNED OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS TERMINATED
DURING CURRENT YEAR**

Column 8	–	Indicate Exercise, Expiration, Maturity or Sale Indicate the cause of termination.
Column 9	–	Termination Date Show the date in which the contract/agreement was terminated. Companies may summarize on one line all identical instruments with the same exchange or counterparty, using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
Column 10	–	Book Value Book value is the sum of cost plus cumulative increase (decrease) by adjustment in book value.
Column 11	–	* Column Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets. Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged. Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.
Column 12	–	Consideration Received on Terminations Show the amount of consideration received.
Column 13	–	Increase (Decrease) by Adjustment This represents the current year’s amortization of the initial cost.
Column 14	–	Gain (Loss) on Termination - Recognized This represents gain (loss) on termination that is not deferred or used to adjust basis of hedged items.
Column 15	–	Gain (Loss) on Termination - Used to Adjust Basis of Hedged Item This represents the gain (loss) on termination that was used to adjust the basis of a hedged item in the current year. It includes the book value of premiums that were allocated to the purchase cost on exercise of an option.
Column 16	–	Gain (Loss) on Termination - Deferred This represents the gain (loss) on termination that was deferred over yearend. This equals consideration received less book value at termination.
Column 17	–	Other Investment/Miscellaneous Income Include current year earned income on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).

SCHEDULE DB – PART B
SECTIONS 1, 2, AND 3

GENERAL INSTRUCTIONS

In each Section, separate derivative instruments into the following categories:

<u>Category</u>	<u>Line Number</u>
Call Options:	
Hedging	0199999
Income Generation	0299999
Other.....	0399999
Subtotal – Call Options	0499999
Put Options:	
Hedging	0599999
Income Generation	0699999
Other.....	0799999
Subtotal – Put Options.....	0899999
Caps:	
Hedging	0999999
Income Generation	1099999
Other.....	1199999
Subtotal – Caps.....	1299999
Floors:	
Hedging	1399999
Income Generation	1499999
Other.....	1599999
Subtotal – Floors	1699999
Insurance Futures Call Options:	
Hedging	1799999
Income Generation	1899999
Other.....	1999999
Subtotal – Insurance Futures Call Options	2099999
Insurance Futures Put Options:	
Hedging	2199999
Income Generation	2299999
Other.....	2399999
Subtotal – Insurance Futures Put Options	2499999
Totals:	
Subtotal – Hedging	2599999
Subtotal – Income Generation	2699999
Subtotal – Other	2799999
Total.....	9999999

Column 1 – Description

Give a complete and accurate description of the derivative instrument, including a description of underlying securities, currencies, rates, indices, commodities, derivative instruments or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.

Column 2	–	Number of Contracts or Notional Amount	Where instrument positions are traded based on number of contracts, such as exchange traded options, show the number of contracts. For other instruments, such as caps and floors, show the notional amount (i.e., the amount upon which the next cash payment is based). Notional amount should be based on current U.S. equivalent of the amount receivable from the counterparty as of the (purchase/sale/reporting) date.
Column 3	–	Date of Maturity, Expiry or Settlement	Show the date of maturity, expiry or settlement, as appropriate.
Column 4	–	Strike Price, Rate or Index	Show the strike price, rate or index for which an option could be exercised or which would trigger a cash payment on a cap or floor. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$).
Column 5	–	Date of Issuance/Purchase	<p>Show the date of the original transaction. The reporting entity may summarize on one line, all identical derivative instruments used in hedging transactions with the same exchange or counterparty showing the date of last transaction, but only if the instruments are identical in their terms; e.g., type, maturity, expiry or settlement, and strike price, rate or index. Similarly, the reporting entity may summarize on one line, all identical derivative instruments used in income generation transactions with the same exchange or counterparty inserting last transaction date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).</p> <p>Hedging and income generation derivative instruments for which the alternative accounting treatment is chosen should be summarized separately.</p>
Column 6	–	Exchange or Counterparty	If exchange traded, show the name of the exchange, Board of Trade, or contract market. If OTC traded, show the counterparty or guarantor upon whose credit the insurer relies.
Column 7	–	Consideration Received	Indicate the consideration received for sale of the instrument written.

SCHEDULE DB – PART B – SECTION 1

**OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS WRITTEN AND
IN FORCE DECEMBER 31 OF CURRENT YEAR**

Column 8 – Book Value

Book value is the sum of consideration received plus cumulative increase (decrease) by adjustment in book value, if any.

Income Generation Transactions

For covered calls and covered puts, book value equals consideration received. For covered caps and floors, book value is the sum of consideration received plus cumulative increase (decrease) by adjustment in book value, if any.

Column 9 – * Column

Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.

Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.

Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

Column 10 – Statement Value

Hedging Transactions

Instruments shall be valued as follows providing the transaction is permitted by law or regulations of an insurer’s state of domicile (for more complete and detailed explanation, see the NAIC *Accounting Practices and Procedures Manual*):

a. For Hedges of Items Carried at Amortized Cost

(i) Value at amortized cost, (or alternatively at cost if less than one year maturity).

(ii) If during the life of the instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the instrument shall be valued at current market value (marked to market) and changes will be recognized currently.

b. For Hedges of Items Carried at Market Value

Value at current market price (marked to market) and changes will be recognized currently.

c. For Hedges Adjusting the Basis of the Hedged Item (Fixed Income Only)

The book value of an instrument may be used to adjust the basis of the hedged item directly. Prior to entering into the transaction, the insurer must state its intent to use this alternative and may not change methods while the transaction remains open.

Income Generation Transactions

- a. If Underlying/Covering Item Carried at Amortized Cost:
 - (i) For covered puts and calls, value at consideration received.
 - (ii) For covered caps and floors, value at amortized value. If less than one year maturity to from date of acquisition, item may be carried at consideration received (unamortized).
- b. If Underlying/Covering Item Carried at Market Value:
 - (i) Value at current market price (marked to market) and changes will be recognized currently.
- c. If Adjusting the Basis of the Underlying/Covering Item (Fixed Income Only):
 - (i) The book value of a call option may be used to adjust the basis of the underlying/covering asset directly if the call option has a maturity of greater than one year from date of acquisition.

Other Derivative Transactions

Instruments shall be valued at current market price (marked to market). For insurance options, this statement value represents the value as of December 31, of the prior year.

Column 11 – Fair Value

Fair value can be obtained from any one of five sources:

- a. Public Market Quotes
- b. Fair Value Provided by Broker
- c. Management Estimate
- d. Pricing Service
- e. Pricing Matrix

Column 12 – Increase (Decrease) by Adjustment

This represents the current year's amortization of the initial proceeds.

Column 13 – Used to Adjust Basis

Hedging Transactions:

This represents the consideration used to adjust the basis of the hedged item(s) during the current year.

Income Generation Transactions:

This represents the consideration used to adjust the basis of the underlying/covering asset during the current year.

Column 14 – Other Investment/Miscellaneous Income

Hedging Transactions:

Include current year incurred interest expense on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).

Income Generation Transactions:

Include current year incurred interest expense on caps and floors as a negative number. The reporting entity should keep records for more detailed reporting of expense (i.e. incurred versus paid).

Other Derivative Transactions:

Include current year incurred interest expense on caps and floors as a negative number.

SCHEDULE DB – PART B – SECTION 3

**WRITTEN OPTIONS, CAPS, FLOORS AND INSURANCE FUTURES OPTIONS TERMINATED
DURING CURRENT YEAR**

Column 8	–	Indicate Exercise, Expiration, Maturity, or Closing Purchase Transaction Indicate the cause of termination.
Column 9	–	Termination Date Show the date in which the contract/agreement was terminated. Companies may summarize on one line all identical derivative instruments used in hedging transactions with the same exchange or counterparty, using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index). Similarly, the reporting entity may summarize on one line, all identical derivative instruments used in income generation transactions with the same exchange or counterparty using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index). Hedging and income generation derivative instruments, for which the alternative accounting treatment is chosen, should be summarized separately.
Column 10	–	Book Value Hedging Transactions: Book value is the sum of consideration received plus cumulative increase (decrease) by adjustment in book value, if any. Income Generation Transactions: For covered calls and covered puts, book value equals consideration received. For covered caps and floors, book value is the sum of consideration received plus cumulative decrease by adjustment in book value, if any. Other Derivative Transactions: For other derivative transactions, book value equals consideration received.
Column 11	–	* Column Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets. Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged. Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

Column 12	–	Consideration Paid on Termination
		Show the amount of consideration paid.
Column 13	–	Increase/(Decrease) by Adjustment
		This represents the current year's amortization of the initial proceeds.
		This equals book value at termination less consideration paid on termination.
Column 14	–	Gain (Loss) on Termination - Recognized
		This represents gain (loss) on termination that is not deferred or used to adjust basis of hedged or underlying/covering items.
Column 15	–	Gain (Loss) on Termination - Used to Adjust Basis
		Hedging Transactions:
		This represents the gain (loss) on termination that was used to adjust the basis of a hedged item in the current year. It includes the book value of premiums that were allocated to the sale proceeds on exercise of an option.
		Income Generation Transactions:
		This represents the gain (loss) on termination that was used to adjust the basis of an underlying/covering item in the current year. It includes the book value of premiums that were allocated to the sale proceeds on exercise of an option.
Column 16	–	Gain (Loss) on Termination - Deferred
		This represents the gain (loss) on termination that was deferred over yearend.
Column 17	–	Other Investment/Miscellaneous Income
		Hedging Transactions:
		Include current year incurred interest expense on caps and floors. The reporting entity should keep records for more detailed reporting of income (i.e., paid versus accrued).
		Income Generation Transactions:
		Include current year incurred interest expense on caps and floors as a negative number. The reporting entity should keep records for more detailed reporting of expense (i.e. paid versus accrued).
		Other Derivative Transactions:
		Include current year incurred interest expense on caps and floors as a negative number.

SCHEDULE DB – PART C
SECTIONS 1, 2 AND 3

GENERAL INSTRUCTIONS

In each Section, separate derivative instruments into the following categories:

	<u>Category</u>	<u>Line Number</u>
Collars:		
	Hedging.....	0199999
	Other	0399999
	Subtotal – Collars.....	0499999
Swaps:		
	Hedging.....	0599999
	Other	0799999
	Subtotal – Swaps.....	0899999
Forwards:		
	Hedging.....	0999999
	Other	1199999
	Subtotal – Forwards	1299999
Totals:		
	Subtotal – Hedging.....	2599999
	Subtotal – Other	2799999
Total.....		9999999

Column 1	–	Description
		Give a complete and accurate description of the derivative instrument, including description of underlying securities, currencies, rates, indices, commodities, derivative instruments or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.
Column 2	–	Notional Amount
		Where instrument positions are traded based on number of contracts, such as exchange traded options or futures, show the number of contracts. For other instruments, such as swaps, show the notional amount (i.e., the amount upon which the next cash payment is based).
Column 3	–	Date of Maturity, Expiry or Settlement
		Show the date of maturity, expiry or settlement, as appropriate.
Column 4	–	Strike Price, Rate, or Index Rec (Pay)
		Show the price, rate or index relative to which profits and losses on the transaction are determined (such as (paid) and received interest rate on an interest rate swap), or that is locked in, as under a currency forward. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$).

Column 5	–	Date of Opening Position or Agreement
		Show the date of the original transaction. The reporting entity may summarize on one line, all identical instruments with the same exchange or counterparty using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
Column 6	–	Exchange or Counterparty
		If exchange traded, show the name of the exchange, Board of Trade, or contract market. If OTC traded, show the counterparty or guarantor upon whose credit the insurer relies.
Column 7	–	Cost or (Consideration Received)
		Indicate the cost or (consideration received), if any.

SCHEDULE DB – PART C – SECTION 1

COLLAR, SWAP AND FORWARDS OPEN
DECEMBER 31 OF CURRENT YEAR

Column 8 – Book Value

Book value is the sum of cost paid or consideration received plus cumulative increase (decrease) by adjustment in book value.

Column 9 – * Column

Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets.

Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged.

Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.

Column 10 – Statement Value

Instruments shall be valued as follows providing the transaction is permitted by law or regulations of an insurer’s state of domicile.

a. For Hedges of Items Carried at Amortized Cost:

(i) Value at amortized cost, (or alternatively at cost if less than one year maturity).

(ii) If during the life of the instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the instrument shall be valued at current market value (marked to market) and changes will be recognized currently.

b. For Hedges of Items Carried at Market Value

Value at current market price (marked to market) and changes will be recognized currently.

c. For Hedges Adjusting the Basis of the Hedged Item

The book value of an instrument may be used to adjust the basis of the hedged item directly. In this case the statement value of the instrument would be zero.

d. For Other Derivatives Transactions

Value at current market price (marked to market) and changes will be recognized currently.

Column 11	–	Fair Value
		Fair value can be obtained from any one of five sources:
		<ul style="list-style-type: none"> a. Public Market Quotes b. Fair Value Provided by Broker c. Management Estimate d. Pricing Service e. Pricing Matrix
Column 12	–	Increase (Decrease) by Adjustment
		This represents the current year's amortization of the initial cost or proceeds.
Column 13	–	Used to Adjust Basis of Hedged Item
		This represents the amortized book value used to adjust the basis of the hedged item(s) during the current year.
Column 14	–	Other Investment/Miscellaneous Income
		Include current year earned income on collars and swaps. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).
Column 15	–	Potential Exposure
		Potential Exposure is a statistically derived measure of the potential increase in derivative instrument credit risk exposure, for derivative instruments which generally do not have an initial cost paid or consideration received, resulting from future fluctuations in the underlying interests upon which derivative instruments are based.
		For collars, swaps and forwards, the Potential Exposure = 0.5% x "Notional Amount" x Square root of (Remaining Years to Maturity).

SCHEDULE DB – PART C – SECTION 3

**COLLAR, SWAP AND FORWARDS TERMINATED
DURING CURRENT YEAR**

Column 8	–	Indicate Exercise, Expiration, Maturity or Sale Indicate the cause of termination.
Column 9	–	Termination Date Show the date in which the contract/agreement was terminated. Companies may summarize on one line all identical instruments with the same exchange or counterparty, using the latest termination date, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement, and strike price, rate or index).
Column 10	–	Book Value Book value is the sum of cost plus cumulative increase (decrease) by adjustment in book value.
Column 11	–	* Column Insert “*” in this column if the book value is combined with the book value of assets or liabilities hedged, the book value is combined with the book value of underlying/covering assets or if the amount is combined with consideration paid on underlying/covering assets. Insert “#” in this column if the book value was combined in prior years with the book value of assets or liabilities hedged. Insert “@” in this column if the income/expenses is combined with income/expenses on assets or liabilities hedged.
Column 12	–	Consideration Received or (Paid) on Termination Show the amount of consideration received or paid.
Column 13	–	Increase/(Decrease) by Adjustment This represents the current year’s amortization of the initial cost or proceeds.
Column 14	–	Gain (Loss) on Termination - Recognized This represents gain (loss) on termination that is not deferred or used to adjust the basis of hedged items.
Column 15	–	Gain (Loss) on Termination - Used to Adjust Basis of Hedged Item This represents the gain (loss) on termination that was used to adjust the basis of a hedged item in the current year.
Column 16	–	Gain (Loss) on Termination - Deferred This represents the gain (loss) on termination that was deferred over yearend. This equals consideration received less book value at termination.
Column 17	–	Other Investment/Miscellaneous Income Include current year earned income on collars and swaps. The reporting entity should keep records for more detailed reporting of income (i.e., collected versus accrued).

SCHEDULE DB – PART D
SECTIONS 1, 2 AND 3

GENERAL INSTRUCTIONS

In each Section, separate derivative instruments into the following categories:

<u>Category</u>	<u>Line Number</u>
Long Futures:	
Hedging	0199999
Other.....	0399999
Subtotal – Long Futures	0499999
Short Futures:	
Hedging	0599999
Other.....	0799999
Subtotal – Short Futures	0899999
Insurance Futures Call Options:	
Hedging	1799999
Other.....	1999999
Subtotal – Insurance Futures Call Options	2099999
Insurance Futures Put Options:	
Hedging	2199999
Other.....	2399999
Subtotal – Insurance Futures Put Options	2499999
Totals:	
Subtotal – Hedging	2599999
Subtotal – Other	2799999
Total.....	9999999

At the end of each Section, list, in alphabetical sequence, brokers with whom cash deposits have been made.

Column 1	–	Description
		Give a complete and accurate description of the derivative instrument, including description of underlying securities, currencies, rates, indices, commodities, derivative instruments or other financial market instruments. Forward exchange rate must be stated as: Fx Currency per US\$ (Fx/US\$). Where leveraging is a feature of the payment terms, the multiplier effect will be clearly presented in the description. Two or more lines may be used to report a derivative instrument if such presentation provides a more accurate description.
Column 2	–	Number of Contracts
		Show the number of contracts.
Column 3	–	Maturity Date
		Show the date of maturity.

SCHEDULE DB – PART D – SECTION 1

FUTURES CONTRACTS AND INSURANCE FUTURES CONTRACTS OPEN
DECEMBER 31 OF CURRENT YEAR

Columns 4 and 5	–	Original Value & Current Value Column 4 (Original Value) and 5 (Current Value) – Represent the original or current value of open contracts even though this amount was not paid or received in cash. It equals (# of contracts) x (underlying value per contract) x (price per contract).
Column 6	–	Variation Margin On long contracts, it is the difference between Current Value minus Original Value (Column 5 – Column 4). On short contracts, it is the difference between Original Value minus Current Value (Column 4 – Column 5).
Column 7	–	Date of Opening Position Show the date of the original transaction. Summarize on one line and use the date of last transaction for instruments with the same exchange sign.
Column 8	–	Exchange or Counterparty Show the name of the exchange, Board of Trade, or contract market.
Column 9	–	Cash Deposit Show at the end of this section the amount of outstanding cash deposits at December 31, by broker, in alphabetical sequence.
Column 10	–	Variation Margin Information - Recognized This represents the variation margin recognized as an unrealized or realized gain (loss) or as investment income from inception of the contract.
Column 11	–	Variation Margin Information - Used to Adjust Basis of Hedged Item This represents the variation margin used to adjust the basis of a hedged item.
Column 12	–	Variation Margin Information - Deferred This represents the variation margin that has been deferred from inception of the contract.
Column 13	–	Potential Exposure Potential Exposure is a statistically derived measure of the potential increase in derivative instrument credit risk exposure, for derivative instruments which generally do not have an initial cost paid or consideration received, resulting from future fluctuations in the underlying interests upon which derivative instruments are based. For futures, the Potential Exposure = (Initial Margin per contract on the valuation date, set by the exchange on which contract trades) x (the number of contracts open on the valuation date).

SCHEDULE DB – PART D – SECTION 2

**FUTURES CONTRACTS AND INSURANCE FUTURES CONTRACTS OPENED
DURING CURRENT YEAR**

- Column 4 – Original Value
- Original value represents the original value of the contracts purchased or sold even though this amount was not paid or received in cash. It equals (# of contracts) x (underlying value per contract) x (price per contract).
- Column 5 – Date of Opening Position
- Show the date of the original transaction. Companies may summarize on one line all identical instruments with the same exchange using the date of last transaction.
- Column 6 – Exchange or Counterparty
- Show the name of the exchange, Board of Trade, or contract market.
- Column 7 – Net Additions to Cash Deposits
- Show at the end of this section the net additions of cash deposits during the year, by broker, in alphabetical sequence.

SCHEDULE DB – PART D – SECTION 3

**FUTURES CONTRACTS AND INSURANCE FUTURES CONTRACTS TERMINATED
DURING CURRENT YEAR**

Column 4 and 5	–	Original Value & Termination Value Column 4 (Original Value) and 5 (Termination Value) – Represent the original or termination value of terminated contracts even though this amount was not paid or received in cash. It equals (# of contracts) x (underlying value per contract) x (price per contract) less commission on terminated contracts.
Column 6	–	Variation Margin On long contracts it is the difference between Termination Value minus Original Value (Column 5 – Column 4). On short contracts it is the difference between Original Value minus Termination Value (Column 4 – Column 5).
Column 7	–	Date of Opening Position Show the date of the original transaction. Summarize on one line and use the date of last transaction for instruments with the same exchange sign.
Column 8	–	Exchange or Counterparty Show the name of the exchange, Board of Trade, or contract market.
Column 9	–	Net Reduction to Cash Deposits Show at the end of this section the net reductions of cash deposits during the year by broker, in alphabetical sequence.
Column 10	–	Termination Date Show the date in which the contract was terminated. Summarize on one line and use the date of last transaction for instruments with the same exchange sign, but only if the instruments are identical in their terms, (e.g., type, maturity, expiry or settlement).
Column 11	–	Variation Margin Information – Gain (Loss) Recognized This represents the total variation margin that was recognized as realized or unrealized gain (loss), or as investment income from inception of the contract.
Column 12	–	Variation Margin Information – Gain (Loss) Used to Adjust Basis of Hedged Item This represents the variation margin that was used to adjust the basis of a hedged item. It includes the variation margin that was allocated to the purchase cost or sales proceeds when delivery was taken or made on the underlying items of the futures contract.
Column 13	–	Variation Margin Information – Gain (Loss) Deferred This represents the variation margin that was deferred over yearend.

SCHEDULE DB – PART E – SECTION 1

COUNTERPARTY EXPOSURE FOR DERIVATIVE INSTRUMENTS OPEN **DECEMBER 31 OF CURRENT YEAR**

Counterparty Exposure to any one counterparty is the exposure to credit risk associated with the use of derivative instruments with that counterparty. This part displays the statement value exposure and market value exposure to each counterparty, net of collateral. Also displayed is the total potential exposure for each counterparty for Schedule DB, Parts C and D.

On the first line, show the aggregate sum for exchange traded derivatives. On subsequent lines, show separately six groups of OTC (over-the-counter) derivative counterparties by SVO Rating. Within each group, list the counterparties in alphabetical order. For each counterparty with a master agreement, show on a second line, if applicable, totals for derivative instruments not covered by the master agreement, and use additional lines as needed if multiple master agreements with the counterparty exist that do not provide for netting of offsetting amounts by the insurer against the counterparty upon termination in the event that the counterparty defaults. Show subtotals for each group.

If an insurer has any detail lines reported for any of the following required groups, it shall report the subtotal amount of the corresponding group with the specified subtotal line number appearing in the same manner and location as the pre-printed total.

Aggregate Sum of Exchange Traded Derivatives.....	0199999
Total NAIC 1 Designation.....	0299999
Total NAIC 2 Designation.....	0399999
Total NAIC 3 Designation.....	0499999
Total NAIC 4 Designation.....	0599999
Total NAIC 5 Designation.....	0699999
Total NAIC 6 Designation.....	0799999
Total.....	0899999

Column 1 – Description Counterparty or Exchange Traded

On the first line, show the phrase: Exchange Traded. On subsequent lines, show the name of the counterparty.

Column 2 – Master Agreement (Yes or No)

Show XXX for the aggregate reporting of Exchange Traded derivatives. For OTC Counterparties, indicate yes if:

1. The insurer has a written International Swaps and Derivatives Association (ISDA) master agreement with the counterparty that provides for the netting of offsetting amounts by the insurer against the counterparty upon termination in the event that the counterparty defaults, or if such netting provisions of an ISDA master agreement are either incorporated by reference in transaction confirmations or are otherwise contractual provisions to which derivative instrument confirmations with the counterparty are subject, or if the insurer has a written non – ISDA master agreement with the counterparty that provides for the netting of offsetting amounts or the right of offset by the insurer against the counterparty upon termination in the event that the counterparty defaults; and
2. The domiciliary jurisdiction of such counterparty is either within the United States or if not within the United States, is within a foreign (non-United States) jurisdiction listed in the *Purposes and Procedures* Manual of the NAIC Securities Valuation Office as eligible for netting.

Column 3 – Fair Value of Acceptable Collateral

Leave blank for the aggregate reporting of Exchange Traded derivatives. For OTC Counterparties, show the market value of acceptable collateral pledged by the counterparty.

“Acceptable collateral” means cash, cash equivalents, securities issued or guaranteed by the United States or Canadian governments or their government-sponsored enterprises, letters of credit, publicly traded obligations rated 1 by the SVO, government money market mutual funds, and such other items as may be defined as acceptable collateral in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. For purposes of this definition, the term “letter of credit” means a clean, irrevocable and unconditional letter of credit issued or confirmed by, and payable and presentable at, a financial institution on the list of financial institutions meeting the standards for issuing such letter of credit published pursuant to the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. The letter of credit must have an expiration date beyond the term of the subject transaction.

Statement values that are debit balances on the balance sheet are positive numbers; those that are credit balances are negative numbers.

Column 4 – Contracts with Statement Value > 0 (i.e., debit balance on balance sheet)

On the first line, show the aggregate sum for exchange traded derivatives that have a positive statement value. For futures, this equals deferred variation margin losses (Part D, Section 1, Column 12); plus the sum of all cash deposits with brokers (Part D, Section 1, Column 9). On subsequent lines, show the sum of the statement values of all derivative instruments with the counterparty that have a positive statement value.

Column 5 – Contracts with Statement Value < 0 (i.e., credit balance on balance sheet)

On the first line, show the sum of the statement values in parentheses () of all exchange traded derivatives that have a negative statement value. For Futures, this equals deferred variation margin gains (Part D, Section 1, Column 12). For written options, caps and floors on Part B, the positive statement values will be shown here in parentheses (). On subsequent lines, show the sum of the statement values in parentheses () of all derivative instruments with the counterparty that have a negative statement value.

Column 6 – Exposure Net of Collateral

For the aggregate reporting of exchange traded derivatives, show amount in Column 4. For OTC Counterparties, if no master agreement is in place, show the sum of the statement values of all derivative instruments with the counterparty, which have a positive statement value, less any Acceptable Collateral (Column 4 – Column 3). If a master agreement is in place, show the net sum of the statement values of all derivative instruments with the counterparty, less any acceptable collateral (Column 4 + Column 5 – Column 3). This amount should not be less than zero.

Market values that would be debit balances on the balance sheet are positive numbers; those that would be credit balances are negative numbers.

Column 7 – Contracts With Fair Values > 0 (i.e., would be a debit balance on the balance sheet)

On the first line, show the sum of the market values of all exchange traded derivatives that have a positive market value. For futures, this equals the sum of all cash deposits with brokers (Part D, Section 1, Column 9). On subsequent lines, show the sum of the market values of all derivative instruments with the counterparty that have a positive market value.

- Column 8 – Contracts With Fair Values < 0 (i.e., would be a credit balance on the balance sheet)
- On the first line, show the sum of the market values in the parentheses () of all exchange traded derivatives that have a negative market value. For futures this equals zero. For written options, caps and floors on Part B, the positive market values will be shown here in parentheses (). On subsequent lines, show the sum of the market values in parentheses () of all derivative instruments with the counterparty that have a negative market value.
- Column 9 – Exposure Net of Collateral
- For the aggregate reporting of exchange traded derivatives, show amounts in Column 7. For OTC counterparties, if no master agreement is in place, show the sum of the market values of all derivative instruments with the counterparty which have a positive market value, less any acceptable collateral (Column 7 – Column 3). If a master agreement is in place, show the net sum of the market values of all derivative instruments with the counterparty, less any acceptable collateral (Column 7 + Column 8 – Column 3). This amount should not be less than zero.
- Column 10 – Potential Exposure
- Show the potential exposure for Parts C and D for exchange traded derivatives in aggregate and for each OTC counterparty.
- Column 11 – Off-Balance Sheet Exposure
- For Exchange Traded Derivatives, show Column 10.
- For OTC counterparties:
- If Column 2 = yes; show [Column 4 + Column 5 – Column 3 + Column 10] – Column 6 but not less than zero.
- If Column 2 = no; show Column 10.
- Optional: If there is no master netting agreement, companies may still encounter double counting in cases where a premium is received for an off balance sheet derivative transaction, such as an interest rate swap. In such cases, report “no” in Column 2 and calculate off balance sheet exposure on a contract-by-contract basis using the first formula.

NAIC Annual (& Quarterly) Statement Blank
Schedule DB (Derivative Instruments).

ANNUAL STATEMENT FOR THE YEAR 2009 OF THE

SCHEDULE DB – PART A – SECTION 1

Showing all Options, Caps, Floors and Insurance Futures Options Owned December 31 of Current Year

[illegible]**SCHEDULE DB – PART A – SECTION 2**

Showing all Options, Caps, Floors and Insurance Futures Options Acquired During Current Year

[illegible]

E19

Investment

[illegible]

SCHEDULE DB – PART B – SECTION 2

Showing all Options, Caps, Floors and Insurance Futures Options Written During Current Year

[illegible]

SCHEDULE DB – PART B – SECTION 3

Showing all Written Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

[illegible]

SCHEDULE DB – PART C – SECTION 1
Showing all Collar, Swap and Forwards Open December 31 of Current Year

[illegible]

SCHEDULE DB – PART C – SECTION 2
Showing all Collar, Swap and Forwards Opened During Current Year

[illegible]

SCHEDULE DB – PART D – SECTION 2
Showing all Futures Contracts and Insurance Futures Contracts Opened During Current Year

[illegible]

SCHEDULE DB – PART D – SECTION 3
Showing all Futures Contracts and Insurance Futures Contracts Terminated During Current Year

[illegible]