National Association of Insurance Commissioners & The Center for Insurance Policy and Research

To: Receivership and Insolvency (E) Task Force

From: IRMA Section 711 Subgroup

Date: February 27, 2012

Re: IRMA Section 711 Research Project

OVERVIEW OF PROJECT

The Receivership and Insolvency (E) Task Force (RITF) charged the IRMA Section 711 Subgroup with the project of studying IRMA Section 711. The goals of the study included: 1) providing RITF members with a better understanding of the purpose, operational mechanics and implications of IRMA 711; 2) assisting RITF members in understanding any policy issues associated with IRMA711 *or* with the absence of IRMA 711; and 3) providing receivership-focused input on regulatory issues associated with qualified financial contracts.

INFORMATION GATHERING

Research Topics Released for Comments
On November 15, 2011, the Subgroup released four research topics for comment through January 20, 2012.

1. *Identify any impact of IRMA 711 on policyholders in a receivership context. (i.e. insurance receivers' experience and perspective)*
2. *Consider the following questions regarding existing setoff/netting rules:*
   a. *What setoff/netting/closeout rules, other than IRMA 711, do states have in place?*
   b. *To what degree does IRMA 711 change the outcome when other setoff / netting or other rules exist?*
      i. *Compare to treatment of secured creditor priority claims*
      ii. *Compare to treatment of collateral absent IRMA 711*
      iii. *Compare to general setoff rules*
      iv. *Evaluate impact of IRMA 711 on <u>timing</u> as opposed to impact on <u>outcome</u>*
3. *Identify any concerns regarding arguably unintended consequences or uses, or with outlier results. Examples for discussion purposes may include:*
   a. *Accelerated collateral postings on the eve of default*
   b. *Synthetic loans or other products that theoretically borrow the QFC netting and collateral rules.*
4. *Consider whether Dodd-Frank Title VII derivative rules (or other new legal developments), including movement from over-the-counter to exchange traded products, impact IRMA 711 – both operationally and regarding policy significance. (i.e. input on implications of Dodd-Frank Title VII and its implementing rules, or any other recent developments)*

A comment letter was received from the American Council of Life Insurers.

Presentations from Industry Experts
On January 13, 23 and 26, 2012, the Subgroup held conference calls to hear presentations from industry experts on the following research topics.

Panel #1: Background on the use, regulation and reporting of QFCs, such as derivatives, in the receivership context.

- Ed Toy and Michele Wong—NAIC Capital Markets Bureau
- Patricia Merrill—Genworth Financial, and Richard Miller—Prudential, representing the American Council of Life Insurers

Panel #2: Technical interpretation of the language in IRMA Section 711

- Bill Latza, Scott Le Bouef, Harold Olson and Nathaniel Kunckle— Stroock & Stroock & Lavan LLP
- Doug Hartz—Insurance Regulatory Consulting Group
- Patrick Cantilo—Cantilo & Bennett LLP

Panel #3: Non-insurance bankruptcies under Section-711-like provisions

- R. Penfield Starke—FDIC
- Locke McMurray—Lehman Brothers Holdings Inc. (Alvarez & Marsal)

KEY TAKE-AWAY POINTS FOR CONSIDERATION

1. IRMA Section 711 provides a safe harbor for QFC counterparties of a domestic insurer. The provision largely tracks similar provisions in the Federal Bankruptcy Code and the Federal Deposit Insurance Act (FDIA), as well as the laws of other foreign jurisdictions, allowing a non-defaulting counterparty to closeout, liquidate and terminate QFCs upon insolvency. These safe harbor provisions for QFCs were adopted to avoid disruptions resulting from judicial intervention that can cause unintended chain reactions and significant systemic impact.
2. Rationales for IRMA 711 include: 1) aforementioned systemic significance; 2) symmetric advantages (insurers in the money enjoy netting and collateral rights in a counterparty bankruptcy); 3) secured nature of the claims making the result generally in line with commercial and regulatory expectations; 4) commercial practicalities (enhanced by Dodd-Frank derivative provisions); and 5) lack of practical alternative to the framework for resolving QFCs.
3. Continued consideration should be given to regulatory issues such as disclosure, circuit breakers, and ability to conduct scenario analysis. Information from the Subgroup's research should be made available to regulators to assess those issues.
4. FDIC has the ability to transfer (within the period of a 24 hour stay in the FDIA) rather than have QFCs all terminate. Financial market instruments typically will have a prohibition on transfers in the contract, but the FDIC can override via this FDIA provision. IRMA Section 711 does not include a 24-hour stay provision similar to the provision contained in the FDIA. Two of the industry experts endorsed the concept of a 24-hour stay provision, but also observed from experience that in some circumstances 24 hours may not be meaningful in creating opportunity to transfer QFC contracts to another entity to avoid default. Working group members have observed that a stay provision could be relevant in limited situations.
5. States should be aware that QFC safe harbor provisions have been submitted to legislatures, which differ in material respects from IRMA 711 Model Act language. These amended versions appear to be greatly expansive in scope and contrary to the stated rationale for IRMA 711. IRMA 711 has also been proposed without the 711(h) exception for affiliate transactions. It is the subgroup's view that a good faith consensus regarding IRMA 711 should include these provisions. States should be given an explanation of any deviations and what IRMA originally intended so that an informed decision can be made on current law (if 711 is adopted as a separate provision).

6. Banks appear to be the primary derivatives dealers. Proposed margin rules issued by bank prudential regulators provide that initial and variation margin for uncleared swaps must be calculated on a gross, rather than net, basis unless the parties are subject to a "qualifying master netting agreement" and obtain a legal opinion that key provisions of this agreement are enforceable, even in the case of bankruptcy or insolvency. Insurers in states which have adopted IRMA Section 711 will have their margin levels calculated on a net basis, while insurers in states which have not adopted IRMA Section 711 will become subject to higher margin requirements based on gross positions.
7. Counterparties do not have to terminate right away and the statutory language does not address how long after default the safe harbor remains in effect, which can cause legal issues with open transactions and monitoring issues for a receiver. Non-insurance experience in managing the issues exists and would need to be drawn on if encountered in an insurance insolvency.
8. Valuation issues can arise with counterparties that wish to terminate, as valuation of derivatives is debatable and changes instantaneously in the market. A receiver might have to build an infrastructure to assess counterparty valuation techniques. Wherever possible, experts counseled advanced planning.
9. IRMA 711(e) provides that the receiver may not avoid a transfer in connection with a netting agreement or QFC except where made with "actual intent to hinder, delay or defraud". Experts discussed that the unraveling remedy for a receiver to regain collateral (for various reasons) from a counterparty that has been foreclosed upon can be a difficult and complicated process.

RECOMMENDATIONS TO FINANCIAL CONDITION (E) COMMITTEE

1. **Promote Uniform Adoption of IRMA Section 711**– Request Financial Condition (E) Committee to urge for the uniform adoption of IRMA Section 711 in conjunction with the IRMA critical elements project.
2. **Estate Inception Issues**– Receivers should consider practical strategies for successfully managing QFC's at estate inceptions. This consideration may include a better understanding of the triggers for an event of default (filing of action, judicial finding, rehabilitation vs. liquidation and fact of insolvency).
3. **State Legislatures Should Consider the 24-hour Stay and Transfer Provisions Consistent with FDIA and Dodd-Frank.** When a state is implementing Section 711, it should consider the 24-hour stay provision and transfer provision similar to FDIA and Dodd-Frank Title II.
4. **Sponsor NAIC Training Webinar on Technical Interpretation of Section 711** – Hold webinars walking regulators and interested legislatures through the technical interpretation and meaning of IRMA Section 711.
5. **Enhance the *Receiver's Handbook for Insurance Company Insolvencies*** – Add explanatory guidance to the Handbook of the legal intent of Section 711 by paragraph and/or line, as well as other pertinent legal considerations and references.
6. **RITF Members to Serve as a Resource for Future Discussions of Related Regulatory Issues**. The RITF members should serve as a resource and continue to contribute to joint discussions with other applicable Task Forces/Working Groups/Subgroups on the regulatory issues such as disclosure, circuit breakers, and ability to conduct scenario analysis. Information from the Subgroup's research should be made available to regulators to assess those issues. These future discussions could include for example: analysis of the need for further disclosures of QFCs and collateral in the Annual/Quarterly Financial Statement Blanks; assessment of the need for additional analysis and examination guidance to encourage monitoring of potential prospective risks that might occur related to QFC levels and collateral positions; and a study of RBC risk charges related to QFCs.