

I. RECEIVERSHIP INVOLVING QUALIFIED FINANCIAL CONTRACTS

A. Insurer Receivership Model Act (IRMA) Section 711 – Qualified Financial Contracts (or Similar Provision)

When financial markets are uncertain, it causes heightened scrutiny in the capital markets and among financial institutions about identifying, managing and limiting risk, the need for adequate capitalization and for understanding the interdependency of the different financial sectors. One source of risk to financial market participants that rises due to the lack of certainty in the financial markets is the treatment of qualified financial contracts (QFC) and netting agreements in the event of the insolvency of state regulated insurers.

1. Definition of Qualified Financial Contract

Insurer Receivership Model Act (IRMA) defines a QFC as “any commodity contract, forward contract, repurchase agreement, securities contract, swap agreement and any similar agreement that the commissioner determines by regulation, resolution or order, to be a qualified financial contract for purposes of this Act.”

- *Commodity contract* is defined by reference to the Commodity Exchange Act (7 U.S.C. § 1) (“Commodity Act”) and is a contract for the purchase or sale of a commodity for future delivery on or subject to the rules of a board of trade or contract market subject to the Commodity Act; an agreement that is subject to regulation under Section 19 of the Commodity Act commonly known as a margin account, margin contract, leverage account or leverage contract; an agreement or transaction subject to regulation under Section 4(b) of the Commodity Act that is commonly known as a commodity option; any combination of these agreements or transactions and any option to enter into these agreements or transactions.
- *Forward Contract, Repurchase Agreement, Securities Contract and Swap Agreement* shall have the meanings set forth in the Federal Deposit Insurance Act, 12 U.S.C. § 1281(e)(8)(D), as amended from time to time.

It should be noted that an insurance contract is not a derivative or a qualified financial contract because an insurance contract includes the indemnification against loss. Therefore reinsurance agreements would not be considered a swap agreement.

2. Insolvency Treatment of QFCs under the IRMA Section 711 Provision

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 laws of other foreign jurisdictions. 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. Section 711 applies in both Rehabilitation and Liquidation proceedings.

Section 711 states that a right to terminate or liquidate or accelerate a close out under a netting agreement or a qualified financial contract with an insurer either due to the insolvency, financial condition or default of the insurer or the commencement of a

formal delinquency proceeding is not prevented by any other provision of IRMA. Section 711 allows a counterparty to net different contracts and realize on collateral without a stay¹.

Section 711 addresses transfer of a netting agreement or QFC of an insurer to another party. In a transfer, the Receiver has to transfer all of the netting agreement or QFC and all of the property and credit enhancements securing claims under the agreement or QFC. This prevents “cherry picking” and requires the transfer of everything, ie. all of both the “in-the-money” and “out-of-the-money” positions.

3. Considerations for QFCs held by an Insurer in Receivership:

- Although the Investments of Insurers Model Act (either Defined Limits or Defined Standards) does not include limits on the amount of collateral an insurer is allowed to post, some states have restrictions on derivatives use, including quantitative limits, and limits on the pledging of collateral, based on type and credit quality. The receiver may also need to determine if a derivative use plan, if required, is in effect and if it dictates any collateral requirements.
- If the ability to net exists and there is no stay requirement, it is important that the regulator understand the QFC portfolio before the insurer's failure, either through a recent or ongoing financial examination or through an assessment made during regulatory supervision that precedes a receivership order, while recognizing that the market value of the derivatives positions can vary substantially over relatively short periods of time. The Receiver also needs to have a good understand of the relationship of the QFC contracts to the rest of the insurer's balance sheet. Because most derivatives transactions are used for hedging purposes, if those contracts are terminated as a result of netting, the assets and liabilities will no longer be hedged.
- The Receiver should be aware that there may be areas of contention and disagreement by parties in the netting, termination and closeout of QFC agreements, for example, disagreement over the valuation or in the resolution of transactions where the parties wait too long to terminate the contract.
- Some counterparties may have been accepting less liquid assets such as private placements based on the relative financial strength of the insurance company, typically, collateral for a QFC will be cash and U.S. treasury bonds. The moving of OTC derivatives to centralized clearinghouses will gradually eliminate less liquid assets as well as assets with more volatile market values being used as collateral. It is also worth noting that it is possible to have non-admitted assets eligible as collateral. Where assets exceed concentration limits, the excess can be collateral without being an admitted asset.
- The impact of central clearinghouses (CCH) will be to standardize documentation and collateral requirements. The standard rules for collateral will be more restrictive and be applicable to all parties. These rules will generally allow for only high quality assets that are more liquid and are expected to have less market value volatility. In addition, all parties will be subject to the same rules for both Initial Margin and Variation Margin. In the past it was not uncommon for counterparties to not require Initial Margin from their higher quality clients. This will not be the case going

forward. Even for derivatives transactions that do not go through central clearing, bank counterparties are facing more stringent capital requirements themselves if their exposures are not properly collateralized.

4. Recommended Procedures for State Insurance Regulators / Receivers:

To the extent possible, in a pre-receivership situation:

- To the extent a company has a small number of large QFC contracts that are important to the overall investment portfolio and operations of the insurer, in pre-receivership and in rehabilitation, the state regulator or receiver should reach out to the counterparty to determine if the counterparty is agreeable to continuing the contract and performing on the contract when the insurer enters receivership.
- Consider practical strategies for successfully managing the netting agreements and QFC's, not only at the inception of the receivership but ongoing during the receivership process.
- The receiver should evaluate the netting agreements and QFCs to gaining an understanding of the triggers for an event of default within the contract (e.g. filing of action, judicial finding, rehabilitation vs. liquidation or fact of insolvency, etc.).
- Carefully review most recent financial statement filings and interim company records to identify the netting agreements and QFCs active at the time of receivership, understand the terms of the agreements, the valuation of the QFCs and identify the securities held as collateral and counterparties to the contract. See Appendix for a Summary of Statutory Annual Statement Reporting of QFCs or the most current Statutory Annual Financial Statement and Instructions.

Once a rehabilitation or liquidation Order has been entered:

- Provide notice of the receivership to counterparties, as appropriate under state law.
- Consider implementing a 24-hour stay on termination of netting agreements and QFCs, if allowed under state law (See *Guideline for Stay on Termination of Netting Agreements and Qualified Financial Contracts—Model GDL 1556*).
- It is important for the receiver to keep track of which transactions have been terminated validly and which have not so that appropriate action can be taken when the validity of the termination is contested.
- Once the set off has occurred, if the Receiver disagrees with the counterparties valuation of either the collateral or the QFC transaction, the Receiver would take the next steps to try to negotiate the correct amount and if unsuccessful pursue legal action.
- Consider engaging an investment expert to assist in the auditing, investigating and management of the netting agreements and QFCs within the investment portfolio. Refer to Chapter 3.VI of this Handbook for more guidance on auditing and investigating the investments of the receivership estate.

II. APPENDIX - QUALIFIED FINANCIAL CONTRACT ANNUAL STATEMENT REPORTING (As of 2013)

The subsequent information provides a general description of how and where qualified financial contracts are reported within the AP&P Manual and the statutory financial statements.

Derivative Instruments

AP&P Disclosure

SSAP 27 – *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*

SSAP 86 – *Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions*

Annual Statement Disclosure

Schedule DB – Part A – *Open Options, Caps, Floors, Collars, Swaps, Swaptions and Forwards*

Schedule DB – Part B – *Open Futures*

Within Part A and Part B, section 1 identifies the contracts open as of the accounting date, and section 2 identifies contracts terminated during the year.

Schedule DB – Part C – *Replication Synthetic Asset Transactions (RSAT)*

Section 1 contains the underlying detail of replicated assets owned at the end of the year. Section 2 is reconciliation between years of replicated assets.

Schedule DB – Part D Section 1 – *Counterparty Exposure for Derivative Instruments Open*

Schedule DB – Part D Section 2 – *Collateral for Derivative Instruments Open*

Notes to Financial Statement – *Derivative Instruments*

Notes to Financial Statement – *Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk*

Notes to Financial Statement – *Debt – FHLB Funding Agreements*

Notes to Financial Statement – *Fair Value Measurements*

Notes to Financial Statement – *Analysis of Annuity Actuarial Reserve and Deposit Liabilities by Withdrawal Characteristics – FHLB Funding Agreements*

On a quarterly basis, the insurer only reports derivative instruments that are open as of the current statement date. Schedule DB – Part A – Section 1 lists the insurer's open options, caps, floors, collars, swaps and forwards. Open futures are reported in Schedule DB – Part B – Section 1, replications are reported in Schedule DB – Part C – Section 1, and counterparty exposure for derivatives instruments are reported in Schedule DB – Part D.

Repurchase Agreements

AP&P Disclosure

SSAP 103 – *Accounting for Transfers and Servicing of Financial Assets and Extinguishing of Liabilities*

Repurchase agreements are disclosed in various investment schedules within the Annual Financial Statement depending on the type of investment. The Investment Schedule General Instructions provides the following list of codes to use in the appropriate investment schedule code column. For example, a bond subject to a repurchase agreement would be detailed in Schedule D Part 1 – *Long-Term Bonds*

Owned and use a code of RA in Code Column.

Codes

- LS – loaned or leased to others
- RA – subject to repurchase agreement
- RR – subject to reverse repurchase agreement
- DR – subject to a dollar repurchase agreement
- DRR – subject to a dollar reverse repurchase agreement

Annual Statement Disclosure

Notes to Financial Statement – *Investments – Repurchase Agreements, Restricted Assets*

Notes to Financial Statement – *Sales, Transfer and Servicing of Financial Assets and Extinguishment of Liabilities*

General Interrogatory – *Investment*

ⁱ Except where the state has adopted *Guideline for Stay on Termination of Netting Agreements and Qualified Financial Contracts*—Model GDL 1556.