PROJECT HISTORY REPORT - 2009

DERIVATIVES INSTRUMENT MODEL REGULATION (#282)

1. Description of the project, issues addressed, etc.

The review of Model 282 was conducted at the request of senior NAIC staff to determine its continued relevance to the NAIC regulatory framework for investments. Senior NAIC staff placed the request for review on the agenda of the Valuation of Securities (E) Task Force in the winter of 2005. The Valuation of Securities (E) Task Force formed the Derivatives Market Study (E) Working Group and charged it with studying the derivatives market to determine whether the NAIC should consider changes in regulation and whether it should discard or revise and retain the Model Regulation. The Working Group concluded that:

- Credit derivatives are a large and growing portion of fixed income markets. Credit derivatives can be a suitable part of insurer investment strategies. Greater participation by insurers in this market is impeded by market infrastructure issues. Insurer participation in derivatives is likely to increase in proportion to improvements in infrastructure.

- The principal risk in credit derivative investment is credit risk. However, other risks arise primarily because credit derivative markets are at an earlier stage of development.

- Risks or issues specific to credit derivatives include:

    - Documentation – Trade documentation processing has not kept up with trade volume. Backlogs could exacerbate market disruptions. The Federal Reserve and trade associations appear to be addressing this issue.

    - Settlement – The outstanding volume of credit derivatives is often several times larger than the outstanding underlying securities available to settle default events. A more robust settlement framework is under development.

    - Legal – Case and statutory law pertaining to enforceability of credit derivative contracts are not as well established as for bonds and loans.

    - Complexity – Cash flow and risk characteristics of credit derivatives are complex. This poses training challenges for investment and risk management professionals and for examiners and regulators.

    - Counterparty concentration risk – One of fourteen large money center banks is a counterparty to most credit derivative contracts. Their net exposure to underlying entities is unknown and could become a performance issue upon occurrence of major credit events.

These considerations led the Working Group to recommend a complete revision in the NAIC approach to derivative investments. The revisions to the Model Regulation must be understood as part of this broader effort to modernize the NAIC regulatory framework for derivatives. The Working Group made the following recommendations and referrals:

- The Capital Adequacy (E) Task Force should consider allowing credit for derivative hedges that reduce an insurer's risk.

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- Certain types of derivative transactions are not captured on NAIC Schedule DB, including derivative transactions by subsidiaries, risk transferred to an insurer via insurance contracts, default swaps written as surety bonds and others.

- NAIC derivative schedules require a complete revision to reduce the number of schedules, elicit information that is relevant and meaningful to regulators and to reflect current derivative practices.

- Derivatives, including credit default swaps, represent a significant portion of financial instruments available for insurers. Public policy and practical financial solvency monitoring procedures require uniform and robust state regulator oversight of this activity. Model Regulation 282 should be revised and retained as a national standard despite the seemingly limited number of states that have embraced the Model Regulation.

- Model Regulation 282 should be revised to require a derivative use plan that has been reviewed and approved by the Commissioner before the company is authorized to engage in derivatives transactions.

2. Name of group responsible for draft the model:

The Derivatives Market Study (E) Working Group of the Valuation of Securities (E) Task Force:

States Participating:
New York, Chair
California, Vice Chair
Connecticut
Delaware
Illinois
Minnesota
Virginia

3. Project authorized by what charge and date first given to the group:

The following charge was given to the Derivatives Market Study (E) Working Group in 2006:

The charge of the Derivatives Market Study (E) Working Group of the Valuation of Securities (E) Task Force is to provide an updated understanding of the derivatives marketplace in order to permit an assessment whether developments in the derivatives marketplace since the early 1990s requires changes in regulation. The findings of the Working Group will be disseminated, among others, to senior NAIC staff to permit a determination whether NAIC Model Regulation 282 should be discarded or revised and retained and if so, in what form.

The Working Group will consider current regulatory guidance for derivatives, hear testimony of participants and experts in the derivatives markets about the derivative market today, consider the activities of insurance companies in the derivatives market and conduct whatever other activities seem appropriate to it in the fulfillment of this charge.

4. A general description of the drafting process (e.g., drafted by a subgroup, interested parties, the full group, etc). Include any parties outside the members that participated.

The amendments to the model act were drafted by the members of the Working Group in public hearings.

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5. A general description of the due process (e.g., exposure periods, public hearings, or any other means by which widespread input from industry, consumers and legislators was solicited.

The Working Group held a series of public meetings during which it took testimony from derivatives experts, federal regulators and industry. Speakers included J. P. Morgan Securities, the International Swaps and Derivatives Association (ISDA), TIAA-CREF, and the Office of Comptroller of the Currency (OCC). In a series of public hearings, the Working Group reviewed the existing NAIC framework for derivatives in which it discussed seeming shortcomings in the NAIC regulatory framework given the testimony it had heard about current derivative practices. It was in this time period that the Working Group identified the issues discussed in paragraph 1 above. It was only at the conclusion of this process that the Working Group turned to a consideration whether the Model Regulation should be revised and retained or discarded. New York led the effort to revise the Model Regulation making proposal for revisions in a series of public hearings and providing ample time for review comment by interested persons. It was during this time frame that the NAIC changed the process governing the amendment of model regulation, so the Working Group concluded its review and made its final recommendations to the Valuation of Securities (E) Task Force. The Task Force suspended work on the Model Regulation while it complied with the new NAIC model law procedure. At the conclusion of that process, the proposed revisions to the Model Regulation were again released for comment and a hearing heard during the NAIC 2009 Spring National Meeting to hear such comments. The Task Force adopted the revisions at the Spring National Meeting.

6. A discussion of the significant issues (items of some controversy) raised during the drafting process and the group's response.

There were two primary changes made to Model Regulation 282. The first was the addition of the requirement of a written derivative use plan that contained a statement of planned derivative activity, the relationship of planned activity to company operations, the policies and procedures that would govern the derivative activity and the command-and-control process that would be employed to manage the risks of derivative transactions. The second change was a requirement that the derivative use plan be reviewed and approved by the Commissioner before the insurer could engage in derivatives transactions.

The proposed prior approval standard was not universally accepted by the members. Some members were concerned that state insurance departments lack the resources to properly evaluate derivative use plans. Other states preferred a file and use standard because they felt it insulated them from legal claims of responsibility for the results of insurer results under derivative use plans. In response to these concerns, the SVO staff conducted legal research and a survey of the states. The legal research supported the view that insurance departments, already responsible for regulation, would be better served by evidence of proactive assessment of the appropriateness of an insurer's planned use of derivatives. The survey demonstrated that while the respondents were almost evenly split on which standard should be reflected in the Model Regulation, there was unanimous agreement that the prior approval standard was most consistent with professional responsibility and reflected best practices. The Valuation of Securities (E) Task Force concluded that the better regulatory response was to require the prior approval standard and that states lacking resources to properly review derivative use plan should rely on the expertise of the Securities Valuation Office for such assessment or prohibit the use of derivatives for companies in that state.

A second issue was in part policy and in part procedural. The policy issue centered on the amended model regulation process: was it a condition to national standard status for the members to be nearly unanimous in their commitment to adopt a model law or regulation? Only four states (CA, CT, IL and NY) could be identified as having adopted the Model Regulation. However, nineteen states had adopted the derivatives portion of the Investment of Insurers Model Regulation (Defined Limits Version). The Valuation of Securities (E) Task Force concluded that the Model Regulation should be retained as a national standard irrespective of the relative level

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of interest by the states, given the nature of derivative transactions and their potential impact on financial solvency of insurers.

7. Any other important information (e.g., amending an accreditation standard).

None.

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