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Regulation of Securities Lending by U.S. Insurers

by John Dembeck

Securities lending has long been an important component of insurance company investment strategies. The New York Insurance Department (the "Department") recently issued guidance on "prudent practices" for all authorized insurers that engage in securities lending. In addition, securities lending by U.S. insurers has been subject to recent changes in statutory financial statement disclosure and related statutory accounting rules. Given all of this recent activity relating to the regulatory framework for securities lending transactions entered into by U.S. insurers, and our work in the securities lending industry, this seems like a good time to review the new New York "prudent practices" guidance on securities lending as well as other existing state insurance laws, statutory financial statement disclosure and related statutory accounting practices and insurer risk-based capital rules as they relate to securities lending by U.S. insurers. Of course, because a securities lending program is a component of an insurance company's broader investment program, the regulatory guidance described in this article should be viewed in the context of, and subject to, the prudence of the overall investment program.

Laws, Regulations and Bulletins

General Survey

Only one-half of the states in the U.S., and the Commonwealth of Puerto Rico, have enacted laws, promulgated regulations or issued published regulatory guidance on securities lending activities by U.S. insurers. Most of these jurisdictions (20) have enacted laws based on or similar to the provisions of the Investments of Insurer Model Act (Defined Limits Version) (the "Model Act") first adopted by the National Association of Insurance Commissioners ("NAIC") in 1996. A few states (3) have provisions that are not necessarily based on the Model Act, and two states, California and New York, have issued guidance by Bulletin (1982) and Circular Letter (2010), respectively.

The Model Act

The Model Act, if enacted in a state, regulates securities lending by insurers domiciled in that state in the following manner:

Authorization. The insurer's board must adopt a written plan that specifies securities lending guidelines and objectives, including: (i) a description of how cash received will be invested or used for general corporate purposes; (ii) operational procedures to manage interest rate risk, counterparty default risk and the use of "acceptable collateral" in a manner that reflects the liquidity needs of the transaction; and (iii) the extent to which the insurer may engage in securities lending transactions. For securities lending transactions, "acceptable collateral" means cash, cash equivalents, letters of credit, direct obligations of, or securities that are fully guaranteed as to principal and interest by, the government of the U.S. or any agency of the U.S., or by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation, and as to lending foreign securities, sovereign debt rated NAIC 1.

Securities Lending Program Size. An insurer may not enter into a securities lending transaction if, as a result of and after giving effect to the transaction, the aggregate amount of all securities then loaned, sold to or purchased from all business entity counterparties under permitted securities lending, repurchase, reserve repurchase or dollar roll transactions combined would exceed 40% of the insurer's admitted assets.

Borrower Concentration and Creditworthiness. An insurer may not enter into a securities lending transaction if, as a result of and after giving effect to the transaction, the aggregate amount of securities then loaned, sold to or purchased from any one business entity counterparty

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The "Own Risk and Solvency Assessment" and its Potential Implications for U.S. Insurers

by Michael K. McDonnell and Sean P. Neenan

As part of its ongoing "solvency modernization initiative," the National Association of Insurance Commissioners is considering the adoption of a new regulatory reporting requirement inspired by the Own Risk and Solvency Assessment, or ORSA, that is part of the Solvency II Framework currently being implemented by the European Union. As envisioned by Solvency II, the ORSA is a self assessment by insurance company groups, undertaken annually, to analyze the group's financial strength in the face of the risks that the group encounters in its business. Among other things, the ORSA will require that a group review and report on changes in its risk profile and assess whether regulatory capital requirements can be met on a continual basis. The ORSA is intended to shed light on the quality and scope of internal risk management and reporting procedures within insurance company groups. In a sense, if an ORSA-style requirement is adopted in the U.S., it will create a regulatory mandate for the enterprise risk management techniques and processes that have become increasingly important within insurance organizations in recent years.

The International Association of Insurance Supervisors ("IAIS"), which is a multinational non-governmental organization that represents the principal insurance regulators of some 190 jurisdictions across the world, recently endorsed the ORSA, and enterprise risk management more generally, as part of a set of "core principles" promulgated to communicate best practices to insurance regulators around the world. In particular, according to the IAIS, a "core principle" of effective insurance regulation is the establishment by a supervisory regime of "enterprise risk management requirements for solvency purposes that require insurers to address all relevant and material risks." In the view of the IAIS, a key component of these requirements

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is the ORSA, defined by the IAIS as "an assessment the insurer makes about the adequacy of the insurer's risk management and current and likely future solvency position … encompass[ing] all reasonably foreseeable and relevant material risks."

The endorsement by the IAIS of the ORSA provides impetus to the NAIC as it seeks, through its solvency modernization initiative, to ensure the continued effectiveness of the U.S. system of insurance regulation. Regulatory deliberations over a potential ORSA requirement in the U.S. featured prominently at the recent fall national meeting of the NAIC, and it appears likely that the NAIC will adopt an ORSA requirement or a very similar concept in the coming years. Among other things, U.S. insurance regulators seem keen to pursue an ORSA requirement because it is likely that the ORSA would focus on insurance groups as a whole, and would not limit itself to an analysis of individual regulated legal entities within a group. The absence in the U.S. of adequate tools to monitor group-wide risks has been noted as a regulatory shortcoming during the recent financial crisis. For example, in its recent Financial Sector Assessment Program (FSAP) Report relating to the U.S. system of insurance regulation, the International Monetary Fund urged U.S. insurance regulators to improve their ability to analyze financial strength on a group-wide basis.

As the ORSA concept is in the early stages of development in the U.S., it still is not entirely clear what an ORSA would require insurers to monitor and report (or even whether the U.S. version will be referred to as an "ORSA" or will take some other name). The NAIC released a discussion paper in August, which put forward such questions to insurers and regulators alike. In the discussion paper, the NAIC queried what should be included in an ORSA, breaking the possible components into two categories, "Risk Management" and "Solvency Assessment." Set out below are some of the significant potential components of an ORSA requirement that the NAIC has highlighted for consideration.

Possible "Qualitative Risk Management" Components of a U.S. ORSA

- Description by the insurance group of risk management and the process used to assess, monitor and communicate risk.
- Identification by the insurance group of significant risks faced by the group and a discussion of its risk appetite, tolerances and limits.
- Identification by the insurance group of emerging risks and new actions that will impact the group's risk profile.
- Identification by the insurance group of recent changes to the group's risk profile.
- Description by the insurance group of risk-mitigation measures, such as: reinsurance, securitization and pooling.
- Description by the insurance group of contingency plans that the group would expect to take under certain circumstances.

Possible "Quantitative Risk Management" Components of a U.S. ORSA

- Quantification and assessment by the insurance group of each significant risk and the assumptions used for such assessment (and related explanation).
- Description and results of forward-looking stress and scenario testing.
- Description of any trends observed.
- Identification by the insurance group of any insurers in the group that have triggered an action based on their risk based capital level or control level and how that is considered in the group's risk management.

Possible "Solvency Assessment" Component of a U.S. ORSA

- A discussion of the insurance group's view of the short- and long-term significant risks and the amount of funds necessary to cover them.
- A discussion of the insurance group's view as to whether its risk-based capital is too low.
- A prospective solvency assessment by the insurance group to attest to the ability to maintain a going concern.
- Disclosure by the insurance group of its target capital level.
- An explanation of the internal models used by the insurance group, including the extent of reliance on outside models.

In addition to the very basic question of what should be analyzed through an ORSA, the discussion paper raised additional questions about how often the insurer would be required to perform the assessment, how forward-looking information provided by insurers would be kept confidential, whether an ORSA would be performed on an entity-specific or group-wide basis (potentially including non-insurance entities) and how the requirements would be adjusted based on the size of an insurer, if at all. To help answer these questions, the NAIC is engaged in a detailed analysis of similar requirements in other jurisdictions. In addition to summarizing the ORSA requirement included within the Solvency II framework, the discussion paper considers similar enterprise risk management requirements in Bermuda, Canada and Switzerland.

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The NAIC has received a large volume of comments in response to its discussion paper. The insurance industry's comments, on the whole, reflect a skeptical view. Among other things, there is a concern that an ORSA requirement, while imposing new and expensive administrative burdens on insurance groups, may duplicate extensive regulatory reporting and examination requirements that have long been in place in the U.S. Others are understandably keen to flesh out the details of the requirement and its implications. Many important questions remain. For example, will the results of an ORSA form the basis for remedial actions by regulators? If an ORSA reveals that an insurance group has particularly strong risk management practices, will that group be the subject of a lesser degree of scrutiny during periodic regulatory examinations? When a U.S. insurer is owned by a non-U.S. parent, what is the insurance group to be reviewed? If companies were to be compared, how would groups that only report on a statutory accounting principles basis be compared with those that report on a GAAP basis? In addition, if an ORSA requirement comes into being, care will be needed to ensure that competitively sensitive data embedded in an ORSA will remain confidential. In any event, although the details are not yet clear at this early stage, the development of an ORSA requirement in the U.S. bears close attention by industry participants and other interested parties. ■

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The New York Court of Appeals Considers Stranger-Originated Life Insurance

by Michael K. McDonnell and Donald H. Guthrie

In New York, Section 3205(b) of the New York Insurance Law codifies the ancient doctrine of "insurable interest" in the law of life insurance, providing that "no person shall procure or cause to be procured, directly or by assignment or otherwise any contract of insurance upon the person of another unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured." According to the New York Insurance Law, an "insurable interest" is either (1) "in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection;" or (2) "in the case of other persons, a lawful and substantial economic interest in the continued life, health or bodily safety of the person insured, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured." The New York Insurance Law, therefore, reflects a longstanding policy, inherent in the common law, in opposition to wagers on human life.

In contrast, Section 3205(a) of the New York Insurance Law provides that "any person of lawful age may on his own initiative procure or effect a contract of insurance upon his own person for the benefit of any person, firm, association or corporation. Nothing herein shall be deemed to prohibit the immediate transfer or assignment of a contract so procured or effectuated." In other words, although a purchaser of life insurance may be prohibited from purchasing coverage on the lives of unrelated individuals in whom the purchaser has no insurable interest, that purchaser has an unrestricted right to purchase life insurance on his or her own life, and in doing so may name any other person as the beneficiary.

A difficult question arises under Sections 3205(a) and (b) when a person purchases life insurance on his or her own life in order to participate in a stranger-originated life insurance scheme, sometimes referred to as a "STOLI" transaction. In such a transaction, an individual might purchase a life insurance policy, naming him- or herself as the insured, and then immediately sell the policy, for a lump sum, to investors. The investors pay the premium on the policy for the life of the insured and, when the insured dies, the investors collect the policy benefits.

In a recent decision that has been of great interest to industry participants and other interested parties, the New York Court of Appeals ruled that Sections 3205(a) and (b) do not prohibit STOLI transactions of this type.[1] Specifically, the court held that "New York law permits a person to procure an insurance policy on his or her own life and immediately transfer it to one without an

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insurable interest in that life, even where the policy was obtained for just such a purpose."

In this particular case, prior to his death in 2008, the insured obtained several policies, with benefits totaling approximately $56 million, and sold them in short order to investors. After his death, the insured's widow claimed the benefits on behalf of his estate. The investors counterclaimed for the benefits, and the relevant insurance companies, in turn, argued that no proceeds should be paid out because the policies were invalid from inception. According to the court, both the insurance companies and the insured's widow urged a finding that a person who purchases a life insurance policy on his own life, with the intent of immediately transferring the policy to another person without an insurable interest, would violate the insurable interest requirement codified in Section 3205(b). The court declined to reach this conclusion. Instead, on the basis of a detailed analysis of the statutory language and related legislative history, the court found that "the Legislature intended to allow the immediate assignment of a policy by an insured to one lacking an insurable interest."

Although this decision is clearly favorable to those interested in pursuing STOLI transactions, its effect in New York will be limited by new legislation that became effective earlier this year. The court noted in its decision that it was not taking these recent legislative changes into account, as they did not come into effect until after the completion of the transactions under consideration. Among other things, the New York Insurance Law now includes strict limitations on policy transfers during the first two years after issuance,[2] and an explicit prohibition against STOLI arrangements. In particular, Section 7815(c) of the New York Insurance Law provides that "[n]o person shall directly or indirectly engage in any act, practice or arrangement that constitutes stranger-originated life insurance." The term "stranger-originated life insurance," in turn, is broadly defined to include the type of transaction considered in the court's recent decision. ■

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1. *Kramer v. Phoenix Life Insurance Co. et al., Slip Op. No. 176 (N.Y. Nov. 17 2010).*

2. *New York Insurance Law § 7813.*

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under permitted securities lending, repurchase, reverse repurchase (for which the netting provisions under a master written agreement are to be given effect) or dollar roll transactions combined would exceed 5% of the insurer's admitted assets. The Model Act imposes no limitations on borrower creditworthiness.

Amount of Collateral. The insurer must receive acceptable collateral having a market value as of the transaction date at least equal to 102% of the market value of the securities loaned by the insurer in the transaction as of that date. If at any time the market value of the acceptable collateral is less than the market value of the loaned securities, the business entity counterparty must be obligated to deliver additional acceptable collateral, the market value of which, together with the market value of all acceptable collateral then held in connection with the transaction, at least equals 102% of the market value of the loaned securities. (See Statutory Financial Statement Disclosure, below, regarding collateral rules for lending certain foreign securities.)

Investment of Cash Collateral. Cash collateral received in a securities lending transaction must be: (i) invested in accordance with the permitted investments otherwise allowed under the Model Act and in a manner that recognizes the liquidity needs of the transaction; or (ii) used by the insurer for its general corporate purposes. For non-cash collateral, for so long as the securities lending transaction remains outstanding, the insurer, its agent or custodian must maintain, as to acceptable collateral received in a transaction, either physically or through the book-entry systems of the Federal Reserve, Depository Trust Company, Participants Trust Company or other securities depositories approved by the state insurance regulator: (i) possession of the acceptable collateral; (ii) a perfected security interest in the acceptable collateral; or (iii) in the case of a jurisdiction outside of the U.S., title to, or rights of a secured creditor to, the acceptable collateral.

Written Agreements. The insurer must enter into a written agreement for all securities lending transactions. The written

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agreement must: (i) be with a business entity counterparty; and (ii) require that the transaction terminate no more than one year from its inception or upon the earlier demand of the insurer. However, the written agreement may be with an agent acting on behalf of the insurer, if: (i) the agent is a "qualified business entity;" (ii) the written agreement requires the agent to enter into separate agreements with each counterparty that are consistent with the Model Act securities lending requirements; and (iii) the written agreement prohibits securities lending transactions under the agreement with the agent or its affiliates. A "qualified business entity" is defined as a business entity that is: (i) an issuer of obligations or preferred stock that are rated NAIC 1 or 2 or an issuer of obligations, preferred stock or derivative instruments that are rated the equivalent of NAIC 1 or 2 or by a nationally recognized statistical rating organization recognized by the Securities Valuation Office of the NAIC; or (ii) a primary dealer in U.S. government securities, recognized by the Federal Reserve Bank of New York.

"Admitted Assets" for Measuring Other Investment Limitations. Securities lending collateral is deducted from the insurer's "admitted assets" as that amount is used for determining any other quantitative investment limitations under the Model Act, such as single and aggregate limitations applicable to certain investment classes.

Unlike the New York Circular Letter (2010) discussed below, the Model Act imposes no securities lending standards on: (i) the maturity of cash collateral investments; or (ii) indemnification by a securities lending agent.

In 2009, the NAIC commenced a project to review the investment limitations of the Model Act. Among the possible changes mentioned with respect to securities lending are reducing the aggregate limitations on these transactions, imposing a limit on securities lending for life insurer separate accounts, limitations on collateral reinvestment and a liquidity requirement. When the NAIC Investment of Insurers Model Act Revision Working Group polled state insurance regulators on possible changes to the Model Act, 100% of respondents agreed that the NAIC should review the 40% admitted asset aggregate limit for securities lending transactions.

New York Circular Letter (2010)

Although securities lending by insurers is not expressly authorized under or subject to any express limitations or restrictions under the New York Insurance Law or Department regulations, securities lending is a permitted practice in New York as part of a prudently operated investment portfolio and has been the subject of a number of Department opinions and pronouncements since 1975.

In 1975, the Department first opined that securities lending was a permitted practice by insurers subject to certain conditions. Specifically, the Department determined that an agreement by a domestic insurer to loan securities to a securities broker was not per se violative of New York Insurance Law § 1411(b) (which required at the time that the disposition of an insurer's property be under the control of the insurer's board of directors). The Department has affirmed that securities lending is a permitted practice for domestic insurers in opinions issued in 1988, 1989 and 2002.

In July 2008, the Department, in its Circular Letter No. 16 (2008) (July 21, 2008), stated that some insurers had engaged in securities lending activity and had experienced significant losses in the prior year. Losses resulted from the fact that cash collateral was reinvested into securities whose value had significantly declined. The Department expressed concern that, with increased volumes in securities lending activity, some insurers may not be maintaining adequate collateral and prudently managing the risks associated with the securities lending. The Department advised that insurers that engaged in securities lending should be sure that they have identified all the risks and have controls in place to manage those risks. In addition, the Department stated that it would place more emphasis on securities lending by insurers by evaluating how well they managed these risks through both the examination of insurers and special requests made on insurers.

From 2008 to 2010, the Department closely examined insurers' securities lending activities. This included the following:

1. The Department served a request, on or about September 22, 2008, for a special report pursuant to New York Insurance Law § 308(a) on various insurers that requested information on the insurer's loaned securities, loan durations, cash collateral investments and security lending counterparties.
2. The Department released financial examination reports as of December 31, 2007 for two New York domestic life insurer affiliates of the American International Group, Inc. – American International Life Assurance Company of New York and First SunAmerica Life Insurance Company – dated January 30, 2009. Each of these examination reports refers to the AIG U.S. securities lending program and each mentions the large amount of losses each insurer

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incurred related to securities lending for 2008.

3. As part of the Department's "Liquidity and Severe Mortality Inquiry" for all licensed life insurers and accredited life reinsurers, the 2009 version of the inquiry asks, among other things, whether the insurer engages in yield enhancing activities such as securities lending. If so, the insurer must: (i) provide a detailed overview of the activities; (ii) explain how the insurer addresses any incremental stress liquidity risk that may be associated with the activities; (iii) disclose how much additional return is generated by each of the activities in terms of portfolio yield; (iv) disclose how the activities are integrated into the insurer's overall risk management practices; (v) identify the specific constraints on the activities; and (vi) disclose what stress testing is performed by the insurer with respect to the activities that might unwind dramatically faster than anticipated.

In Circular Letter No. 2010-16 (Oct. 15, 2010), the Department published "prudent practices" that it believes all authorized insurers should follow in conducting a securities lending program. The Department stated that it had modeled these prudent practices on pre-existing industry practices that it considers prudent in light of the economic events following the U.S. financial crisis of 2008. The Department requested that any authorized insurer whose securities lending practices materially deviate from the "prudent practices" set out by the Department and described below should communicate those material deviations to the Department. Insurers with such deviations likely will need to demonstrate that their securities lending program is prudent when viewed in the context of their investment program as a whole. The prudent risk measures that an insurance company imposes on its own program, as well as how the program correlates with the rest of its investment portfolio, would likely be part of any such demonstration.

Securities Lending Program Size. An authorized insurer should effectively mitigate credit, market, and operational risk by limiting the size of its securities lending program. If an insurer's loan of a particular security, together with its outstanding loans of all other securities, will exceed, when the loan is made, 5% of the insurer's admitted assets as shown by its last sworn statement to the New York Superintendent of Insurance, then the insurer making such a loan may not be acting prudently. It is not clear what the term "admitted assets" is intended to mean with respect to a life insurer – whether the meaning in New York Insurance Law § 107(a)(3) (which includes separate account assets) or the meaning in New York Insurance Law § 1405(b)(1)(B) (which generally excludes separate account assets).

Borrower Concentration and Creditworthiness. An authorized insurer should include securities loans made to any single borrower, together with the borrower's subsidiaries and affiliates, against the 10% of admitted assets single institution investment limitation set forth in New York Insurance Law § 1409(a). The term "admitted assets" as used in New York Insurance Law § 1409(a) has the meaning set forth in New York Insurance Law § 107(a)(3) (which means, in the case of a life insurer, all admitted assets, including its separate account assets). In addition, an authorized insurer engaged in securities lending should establish a management or supervisory committee (the "Securities Lending Risk Management Committee") overseen by its board of directors, to establish guidelines setting forth criteria for evaluating the creditworthiness of a securities borrower. An existing board committee, such as an insurer's audit committee, may assume this role.

Amount of Collateral. An authorized insurer must comply with NAIC Accounting Practices and Procedures Manual (the "Accounting Manual") Statement of Statutory Accounting Principles ("SSAP") No. 91R as it relates to collateral amount requirements. SSAP No. 91R requires insurers to hold cash collateral equal to 102% of the fair value of a loaned security for a domestic security, and 105% of the fair value of a loaned security for a foreign security. If the fair value of the collateral does not meet these standards, the insurer must require the borrower to "true-up" the collateral by delivering additional collateral so that the aggregate collateral levels meet these requirements. The Accounting Manual is updated annually each March and the Department's "prudent practices" refers to SSAP No. 91R as of the March 2009 Accounting Manual. Yet, SSAP No. 91R has already been amended effective for statutory financial statements for 2010. Nevertheless, compliance with these amended securities lending collateral requirements for statutory financial statements for 2010 is likely expected by the Department.

Investment of Cash Collateral. If an authorized insurer receives cash collateral in exchange for a loaned security and invests the cash collateral, then the insurer should mitigate against market

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risk by having its Securities Lending Risk Management Committee establish guidelines for the investment of the cash collateral. These guidelines should set forth prudent investment practices designed to reduce the likelihood of the insurer incurring losses when returning the cash collateral and include the following limits and requirements: limitations on the types of investments made, investment diversification requirements and investment credit quality limitations.

Types of Investments. The Department considers it prudent for an authorized insurer to limit its investments of cash collateral received in securities lending transactions to the following: (i) obligations issued, assumed, guaranteed or insured by the U.S. or by any agency or instrumentality thereof, by any state of the U.S. and by any territory or possession of the U.S. or any other governmental entity in the U.S.; (ii) corporate debt securities; (iii) loan-backed and structured securities; (iv) commercial paper; and (v) money market funds. In addition, an authorized insurer may use cash collateral to enter into reverse repurchase agreements, subject to the following investment diversification requirements.

Investment Diversification. The Department considers it prudent that, in connection with securities lending transactions, an authorized insurer not: (i) invest more than 40% of cash collateral in corporate debt securities, loan-backed or structured securities; or (ii) enter into a reverse repurchase agreement in which the authorized insurer agrees to pledge more than 25% of its available cash collateral to a single counterparty.

Investment Quality. The Department considers it prudent that, in connection with securities lending transactions, an authorized insurer invest cash collateral in: (i) securities designated as NAIC 1; (ii) commercial paper rated A1/P1; or (iii) the following asset classes as classified by the Securities Valuation Office of the NAIC: (x) class 1 mutual fund investments; (y) direct or full faith obligations of the U.S.; and (z) bond mutual funds.

Cash Flow Consideration. An authorized insurer should aggregate its investment of cash collateral with all of its other investment activities, i.e., consider investments of cash collateral in determining the timing and amount of projected cash flows for any financial analyses.

Maturity of Cash Collateral Investments. An authorized insurer should assure that the "maturity date" of an investment made with cash collateral closely matches the date that the cash collateral must be returned to the borrower in exchange for the loaned securities as any mismatch may adversely affect an insurer's balance sheet and negatively impact its surplus. In order to mitigate the risk associated with a mismatch, an authorized insurer should limit the mismatch to no more than one year in the aggregate. For this purpose, "maturity date" means the earlier of the date on the face of the instrument on which the principal amount must be paid or, for an instrument with an unconditional put or unconditional demand feature, the date on which the principal amount of the instrument can be recovered by demand. For asset-backed securities, the maturity date is the expected maturity date.

Indemnification. Where an authorized insurer appoints an agent to execute securities loans on its behalf, the insurer should require in the securities loan agreement that, in the event a borrower fails to return a loaned security and the liquidation proceeds of any investments and collateral are insufficient to purchase a security of the same issuer, issue, class and quantity as the loaned security, the agent will credit the insurer's account in an amount equal to the fair value of the unreturned loaned security minus the liquidation proceeds of any investments made with the cash collateral. In other words, according to the Department, the agent should indemnify the insurer to the extent that the liquidation proceeds of invested collateral fail to cover the cost of acquiring a security equivalent to the loaned security when the loaned security is not returned by the borrower. We note that this requirement is significantly at odds with standard practice in the industry and believe that the risk profile of securities lending programs would be adversely affected if securities lending agents, with their dedicated systems and processes to mitigate risk, were not allowed to participate in such programs.

Written Agreements. All securities lending by an authorized insurer should be memorialized in a written agreement between the lender-insurer and the borrower. If an authorized insurer authorizes an agent to execute securities loans on its behalf, then the agreement with the borrower should be signed by the agent on behalf of the lender-insurer.

Other States

Some key differences in the securities lending rules in the other non-Model Act states are the following:

California. Under the California securities lending rules, (i) the borrower in a securities lending transaction must be a registered securities broker, bank or trust company; (ii) securities loans outstanding to any single borrower may not, at any time,

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exceed the greater of (w) 2% of the insurer's admitted assets, or (x) 10% of the insurer's surplus; and (iii) the amount of outstanding loans of securities to all borrowers may not, at any time, exceed in the aggregate the lesser of (y) 5% of the insurer's admitted assets, or (z) 50% of the insurer's surplus.

Nebraska. The amount of loaned securities may not exceed 10% of the insurer's admitted assets.

New Hampshire. Total securities lending, repurchase agreement or reverse repurchase agreement transactions outstanding with any one entity may not exceed 10% of the insurer's admitted assets. In addition, total securities lending or repurchase or reverse repurchase agreement transactions with all entities may not to exceed 40% of the insurer's admitted assets.

Virginia. Virginia includes no single institution or aggregate limit on securities lending.

Statutory Financial Statement Disclosure

As a result of the attention given securities lending by the AIG life insurers discussed above, the NAIC has enhanced statutory financial statement disclosure of securities lending program activities together with related statutory accounting practices. Disclosure of securities lending programs in the statutory financial statement interrogatories was enhanced for statutory financial statements for 2008 and later and balance sheet and footnote disclosure will be enhanced for statutory financial statements for 2010 and later.

Interrogatory Disclosure. For statutory financial statements for 2007 and prior, U.S. insurers merely had to report in their interrogatories, in the aggregate, the dollar amount of securities "loaned to others." This was in addition to disclosure of other securities that were not under the exclusive control of the insurer, such as those subject to repurchase agreements, reverse repurchase agreements and those pledged as collateral. Interrogatory disclosure of securities lending programs was enhanced with the statutory financial statement for 2008. The reporting insurer must now disclose the following (2009 Interrogatories 22.3-22.6): (i) describe any securities lending program for the reporting insurer, including the value for collateral and the amount of loaned securities and whether collateral is carried on or off balance sheet; and (ii) indicate whether the reporting insurer's securities lending program meets the requirements for a "conforming program" under the NAIC risk-based capital instructions (discussed below under "Risk-Based Capital"). Whether or not the securities lending program meets the requirements for a "conforming program," the aggregate amount of collateral must be reported.

Footnote Disclosure. For statutory financial statements for 2009 and prior, each U.S. insurer had to disclose the following in respect of its securities lending program in Footnote 17(B)(2): (i) a description of any loaned securities, including the fair value, a description of, and the reporting insurer's policy for, required collateral; (ii) whether or not the collateral is restricted (*e.g.*, cannot be sold or repledged); and (iii) the amount of collateral for transactions that extend beyond one year from the financial statement reporting date. This general requirement will continue for statutory financial statements for 2010. However, with the statutory financial statement for 2010, Footnote 5.E disclosure will be enhanced as follows (new 2010 requirements are noted):

1. The reporting insurer must describe its policy for requiring collateral or other security for securities lending transactions as required in SSAP No. 91R (new for 2010).
2. If the reporting insurer or its agent has accepted collateral that it is permitted by contract or custom to sell or repledge, it must be recorded on the reporting insurer's balance sheet (balance sheet recording is new for 2010 – see discussion below).
3. The following information must be provided for the reporting insurer's securities lending program: (i) the aggregate amount of contractually obligated open collateral positions (aggregate amount of securities at current fair value or cash received for which the borrower may request the return of on demand) and the aggregate amount of contractually obligated collateral positions under 30-day, 60-day, 90-day, and greater than 90-day terms; (ii) the aggregate fair value of all securities acquired from the sale, trade or use of the accepted collateral (reinvested collateral); and (iii) information about the sources and uses of that collateral.
4. The following information must be provided with respect to the reinvestment of the cash collateral and any securities which the reporting insurer or its agent receives as collateral that can be sold or repledged: (i) the aggregate amount of the reinvested cash collateral (amortized cost and fair value) – reinvested cash collateral must be broken down by the maturity date of the invested asset – under 30-day, 60-day, 90-day, 120-day, 180-day, less than 1 year, 1-2 years, 2-3 years and greater than 3 years; and (ii) to the extent that the maturity dates of the

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liability (collateral to be returned) does not match the invested assets, the reporting insurer must explain the additional sources of liquidity to manage those mismatches (new for 2010).

Balance Sheet and 5-Year Historical Data Disclosure. Consistent with the instructions for Footnote 5.E disclosure discussed above (*e.g.*, collateral that the reporting insurer is permitted by contract or custom to sell or repledge must be recorded on the balance sheet), the following new statutory financial statement reporting enhancements will be implemented for statutory financial statements for 2010:

1. A new asset Line 10 (Life and Health and Property/Casualty) will be added to the statutory balance sheet titled "Securities Lending Reinvested Collateral Assets." The amounts to be included in this new asset line item will include reinvested collateral assets from a securities lending program where the program is administered by the reporting insurer's unaffiliated agent. If a reporting insurer administers its own securities lending program with no agent, affiliated or unaffiliated, and the collateral it receives can be sold or repledged, the collateral must be reported with the invested assets of the insurer. If a reporting insurer's securities lending program is administered by the insurer's affiliated agent, the insurer may chose either of the preceding two reporting options for collateral – "one-line" reporting or reporting the collateral with the insurer's invested assets.
2. A new liability line (Line 24.10 – Life and Health and Line 22 – Property/Casualty) will be added to the statutory balance sheet titled "Payable for Securities Lending." The amounts to be included in this new liability line item will include liability for securities lending collateral received by the reporting insurer that can be reinvested or repledged. This reporting requirement applies whether the reporting insurer administers the securities lending program itself or engages an affiliated or unaffiliated agent to do so on its behalf.
3. The Five-Year Historical Data page will include a new line item (Line 41 – Life and Health and Line 39 – Property/Casualty) titled "Securities lending reinvested collateral assets" to better allow state insurance regulators to review the 5-year trend for this newly reported asset. This new line item need only be populated prospectively and not retrospectively.

The following other existing financial statement reporting and accounting practices for securities lending remain unchanged:

1. If the securities lending transaction is accompanied by an agreement that entitles and obligates the transferor-insurer to repurchase or redeem the transferred assets before their maturity under which the transferor-insurer maintains effective control over those assets, the transaction is to be accounted for as a secured borrowing. The cash (or securities that the holder or its agent is permitted by contract or custom to sell or repledge) received as collateral is the amount borrowed and the securities loaned are pledged as collateral against the cash or securities borrowed.
2. If the transferor-insurer surrenders control over the securities "loaned" (with the ability to sell or transfer them at will), then the securities lending transaction is to be accounted for: (i) by the transferor-insurer as a sale of the "loaned" securities in exchange for the proceeds consisting of the collateral and a forward repurchase commitment; and (ii) by the transferee-borrower as a purchase of the "borrowed" securities in exchange for the collateral and a forward resale commitment. During the term of the agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities.
3. The reporting insurer must receive collateral having a fair value as of the transaction date at least equal to 102% (105% where foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities) of the fair value of the loaned securities at that date. If at any time the fair value of the collateral received from the counterparty is less than 100% (102% for such foreign securities) of the fair value of the loaned securities, the counterparty must be obligated to deliver additional collateral by the end of the next business day, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 102% (105% for such foreign securities) of the fair value of the loaned securities. If the collateral received from the counterparty is less than 100% at the statutory financial statement reporting date, the difference between the actual collateral and 100% must be nonadmitted.
4. Collateral value is measured and compared to the loaned securities in the aggregate by counterparty.
5. Reinvestment of collateral by the reporting insurer or its agent must follow the same impairment guidance as

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   other similar invested assets reported on the insurer's balance sheet, just as any other invested asset held by the insurer.

6. Any fees received by the transferor-insurer for loaning the securities are recorded as miscellaneous investment income.

These new statutory financial statement reporting items, coupled with the existing reporting items, should give state insurance regulators better tools to evaluate returns from reinvesting collateral received under a securities lending program.

Risk-Based Capital

U.S. insurers must annually calculate and report their required risk-based capital and compare that against their actual capital. The insurer risk-based capital rules attach a risk factor to the insurer's assets and liabilities and generate a risk-based assessment of what capital the insurer needs to support its assets and liabilities. Under the 2009 risk-based capital formula, the risk factor for collateral received under a securities lending program will differ based on whether the insurer's program meets the requirements for a "conforming program." The risk factor for reported collateral for a conforming program is 0.002 while the risk factor for reported collateral for a non-conforming program is 0.013 for life insurers and 0.010 for property/casualty insurers.

For a securities lending program to be a "conforming program," all of the following elements must be present:

1. The reporting insurer's board must adopt a written plan that outlines the extent to which the insurer can engage in securities lending activities and how cash collateral received will be invested.
2. The reporting insurer must have written operational procedures to monitor and control the risk associated with securities lending. Safeguards to be addressed in the procedures must, at a minimum, provide assurance of the following: (i) documented investment guidelines between the lender and the investment manager, with established procedure for review of compliance; (ii) investment guidelines for cash collateral that clearly delineate liquidity, diversification, credit quality and average life/duration requirements; (iii) approved borrower lists and limits to allow for adequate diversification; (iv) the reporting insurer holding excess collateral with the following margin percentages – 102% (or 105% for cross-currency loans); (v) daily mark-to-market of lent securities and obtaining additional collateral needed to maintain margin of 102% of market; and (vi) the transaction not being subject to any automatic stay in bankruptcy and its ability to be closed out and terminated immediately upon the bankruptcy of any party.
3. A binding securities lending agreement (standard "Master Securities Lending Agreement" from Securities Industry and Financial Markets Association) in writing between the reporting insurer, or its agent on behalf of the insurer, and the borrowers.
4. Acceptable collateral – defined as cash, cash equivalents, direct obligations of, or securities that are fully guaranteed as to principal and interest by the government of the U.S. or any agency of the U.S., or by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation and NAIC 1-rated securities (excluding affiliate issued collateral). In all cases, the collateral held must be permitted investments in the state of domicile for the insurer. (This definition of "acceptable collateral" does not completely track the NAIC Model Act definition described above under "Laws, Regulations and Bulletins, The Model Act, Authorization." NAIC 1-rated securities are included under the "conforming program" standards but not the Model Act standard, and letters of credit and NAIC 1-rated sovereign debt, as to lending foreign securities, are included in the Model Act standard but not the "conforming program" standards.)

In addition, if the reporting insurer reports the collateral received in a securities lending transaction with its other invested assets, each invested asset will be assigned the applicable asset risk factor accorded it under the insurer risk-based capital rules.

Conclusion

The changes in statutory financial statement reporting and the related statutory accounting practices for securities lending by insurers coupled with New York's securities lending regulatory initiative seek to provide additional guidance as to the components of a prudent securities lending program, including transparency of collateral held by insurers and the related collateral reinvestment risk and specifically with overall limits on the size of an insurer's securities lending program and limits on the types of collateral investments. Insurers should incorporate the latest regulatory guidance into their evaluation of the prudence of their securities lenders and overall investment programs as they continue to seek to include securities lending as an important element of their investment returns. ■

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