

**NEW YORK STATE
INSURANCE DEPARTMENT**

**FIRST AMENDMENT TO REGULATION NO. 111 (11 NYCRR 175)
RULES GOVERNING BONA FIDE HEDGING TRANSACTIONS**

**FIRST AMENDMENT TO REGULATION NO. 142 (11 NYCRR 177)
RULES GOVERNING BONA FIDE HEDGING AND INCOME ENHANCEMENT TRANSACTIONS
OF AUTHORIZED PROPERTY/CASUALTY INSURERS**

**PROMULGATION OF REGULATION NO. 163 (11 NYCRR 178)
DERIVATIVE TRANSACTIONS**

I, Gregory V. Serio, Superintendent of Insurance of the State of New York, pursuant to the authority granted by Sections 201, 301, 1401, 1403, 1405, 1407, 1410 and 1413 of the Insurance Law and Chapters 650 and 651 of the Laws of 1998, and Chapter 507 of the Laws of 2000, do hereby amend Part 175 of Title 11 (Regulation 111) and Part 177 of Title 11 (Regulation 142) and promulgate a new Part 178 of Title 11 of the Official Compilation of Codes, Rules and Regulations of the State of New York (Regulation 163), to take effect upon publication in the State Register.

(ALL MATERIAL IS NEW)

Part 175 of Title 11 is amended by adding a new Section 175.11 to read as follows:

Section 175.11 Suspension of applicability

Subject to the provisions of Section 178.10 of this Title, the applicability of this Part shall be suspended, in accordance with the provisions of section 11 of Chapter 650 of the Laws of 1998, as amended by section 4 of Chapter 651 of the Laws of 1998, and section 5 of Chapter 507 of the Laws of 2000, until June 30, 2003, unless the provisions of the aforesaid chapters of the Laws of 1998 and 2000 are extended to a later date by the enactment of subsequent legislation, in which case the provisions of the aforesaid chapters shall continue to be effective for the period specified in such subsequent legislation.

Part 177 of Title 11 is amended by adding a new Section 177.8 to read as follows:

Section 177.8 Suspension of applicability

Subject to the provisions of Section 178.10 of this Title, the applicability of this Part shall be suspended, in accordance with the provisions of section 11 of Chapter 650 of the Laws of 1998, as amended by section 4 of Chapter 651 of the Laws of 1998, and section 5 of Chapter 507 of the Laws of 2000, until June 30, 2003, unless the provisions of the aforesaid chapters of the Laws of 1998 and 2000 are extended to a later date by the enactment of subsequent legislation, in which case the

provisions of the aforesaid chapters shall continue to be effective for the period specified in such subsequent legislation.

A new Part 178, entitled "Derivative Transactions", is added to Chapter VI to read as follows:

Section 178.0 Purposes

The purposes of this Part, with respect to derivative instruments used to engage in hedging, replication and certain limited income generation transactions, authorized pursuant to section 1410 of the Insurance Law, are to:

- (a) define certain terms;
- (b) establish the content of the derivative use plan to be submitted by an insurer to the superintendent;
- (c) establish effective management oversight standards, including quarterly reporting to the board of directors or a committee thereof charged with the responsibility for supervising investments;
- (d) require that the insurer establish adequate systems of internal control and reporting to ensure that derivative transactions are properly supervised and that transactions are in accordance with the insurer's authorized policies and procedures;
- (e) establish documentation and reporting requirements; and
- (f) establish appropriate accounting standards.

Section 178.1 Applicability

(a) This Part applies to all domestic and foreign life, property/casualty, reciprocal, mortgage guaranty, co-operative property/casualty and financial guaranty insurers. In addition, this Part applies to foreign fraternal benefit societies and accredited reinsurers. The applicability of this Part to foreign insurers, to foreign fraternal benefit societies and to accredited reinsurers is based upon the provisions of section 1410(k) of the Insurance Law.

(b) No insurer subject to this Part shall enter into derivative transactions, except in accordance with the provisions of this Part.

Section 178.2 Definitions

(a) "Admitted assets" means the assets, as shown on the insurer's last annual statement filed with the superintendent, which conform to the requirements of section 1301 of the Insurance Law, except that a life insurer shall include assets held in separate accounts established under section 4240 of the Insurance Law to the extent of amounts allocated to such separate accounts pursuant to section 4240(a)(3) of the Insurance Law, and shall exclude investments in subsidiaries referred to in section 1704(c) of the Insurance Law.

(b) "Aggregate statement value" means the sum of the statement values of individual derivative instruments. In calculating this sum an insurer shall assign absolute values to negative values.

(c) "Basis risk" means the exposure to loss from imperfectly matched offsetting positions in related but not identical markets.

(d) "Credit risk" means the exposure to loss as a result of default or a decline in market value stemming from a credit downgrade of a counterparty.

(e) “Counterparty exposure amount” means the net amount of credit risk attributable to a derivative instrument entered into with a business entity other than a national securities exchange or board of trade regulated under the laws of the United States:

(1) For an over-the-counter derivative instrument not entered into under or subject to a written master agreement which provides for netting of payments owed by the respective parties: (i) 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 (ii) zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

(2) For over-the-counter derivative instruments entered into under or subject to 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 (not United States) jurisdiction deemed by the superintendent as eligible for netting, the greater of zero or the net sum payable to the insurer in connection with all derivative instruments subject to the written master agreement upon their liquidation in the event of default by the counterparty under the master agreement (assuming no conditions precedent to the obligations of the counterparty to make such a payment and assuming no setoff of amounts payable under any other instrument or agreement).

(3) For the purposes of this definition, market value or the net sum payable, as the case may be, shall be determined at the end of the most recent quarter of the insurer’s fiscal year and will be reduced by the market value of acceptable collateral held by the insurer or a custodian on the insurer’s behalf.

(f) “Foreign currency risk” means the exposure to loss due to fluctuations in foreign exchange rates.

(g) “Interest rate risk” means the exposure to loss due to the potential adverse impact of interest rate movements.

(h) “Market risk” means exposure to loss due to price changes.

(i) “Notional amount” means the nominal face value of the underlying security, currency, index or other instrument used as the basis for calculating payment or settlement under the derivative instrument.

(j) “Operational risk” means the risk of loss occurring as a result of inadequate systems and controls, human error, or mismanagement.

(k) “Option risk” means the exposure to loss due to the uncertainty of cash flows resulting from another party having the right but not the obligation to alter the level and/or timing of cash flows of an asset, liability or off-balance sheet instrument.

(l) “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 = $0.5\% \times \text{notional amount} \times \text{square root of (remaining years to maturity)}$. For futures, the potential exposure = $(\text{initial margin per contract on the valuation date, set by the exchange on which contract trades}) \times (\text{the number of contracts open on the valuation date})$.

Section 178.3 Derivative use plan

(a) (1) The insurer shall submit a derivative use plan, or amendment thereto, to the superintendent for prior approval. The derivative use plan or the amendment thereto will be referred to as “the plan” hereinafter. The filing shall include a certified copy of the authorization by the insurer’s board of directors, or a committee thereof charged with the responsibility for supervising investments, pursuant to section 1410(b)(3)(A) of the Insurance Law. When submitting its plan, the insurer shall also provide to the superintendent: (i) in the event the plan is adopted by a committee of the insurer’s board of directors, information with respect to the composition, in terms of title and position, of such committee and (ii) the name and title of the senior most investment person responsible for derivative transactions; a description of his or her duties and responsibilities, as well as a curriculum vitae or equivalent document. Such information shall be updated and provided to the superintendent as changes occur. The superintendent shall, in writing, either approve the plan, request any additional information needed to approve the plan or deny the plan within ninety days of receipt of the plan; otherwise the plan shall be deemed approved.

(2) If the superintendent requests additional information and the insurer does not provide such information within forty-five days of receipt of such request, then such plan shall be deemed denied. In the event that an insurer properly submits the additional information requested by the superintendent, then the plan shall be deemed approved sixty days after the receipt of the information by the superintendent, unless the insurer is notified in writing prior to such date that the filing has been denied.

(3) A filing will be deemed to be incomplete and fail to comply with regulatory requirements if the filing fails to include: the requisite resolution evidencing approval by the board of directors, or a committee thereof charged with the responsibility for supervising investments, required pursuant to paragraph (1) of subsection (a) of this section; a section on management oversight standards as required by Section 178.4 of this Part; a section on internal controls and reporting as required by Section 178.5 of this Part; and a section on documentation and reporting requirements as required by Section 178.6 of this Part. In such case the superintendent shall return the plan within sixty days of receipt notifying the insurer that no action is being taken and that the period for the superintendent’s review has not commenced.

(b) The plan shall contain written guidelines to be followed in engaging in derivative transactions. The guidelines shall include or address:

- (1) the type, maturity and diversification of derivative instruments;
- (2) the limitation on counterparty exposures, including limitations based on credit ratings;
- (3) the limitations on the use of derivatives;
- (4) asset/liability management practices with respect to derivative transactions;
- (5) the liquidity needs and the company’s capital and surplus as it relates to the derivative use plan;
- (6) the policy objectives of management specific enough to outline permissible derivative strategies;
- (7) the relationship of the derivative strategies to the insurer’s operations;
- (8) a requirement that management establishes and executes management oversight standards as required by Section 178.4 of this Part and a description of these standards;

(9) a requirement that management establishes and executes internal controls and reporting standards as required by Section 178.5 of this Part and a description of these standards; and

(10) a requirement that management establishes and executes documentation and reporting standards as required by Section 178.6 of this Part and a description of these standards.

(c) The plan shall contain, to the extent applicable to the specific derivative transactions authorized, guidelines for the insurer's acceptable levels of basis risk, credit risk, foreign currency risk, interest rate risk, market risk, operational risk and option risk. The plan shall also provide that the board of directors, or a committee thereof charged with the responsibility for supervising investments, and senior management shall comply with risk oversight functions and adhere to laws, rules, regulations, prescribed practices or ethical standards.

Section 178.4 Management oversight standards

(a) In order to address the need for appropriate oversight by senior management and by the board of directors, or a committee thereof charged with the responsibility for supervising investments, and to provide for a comprehensive risk management process for derivative instruments, an insurer shall establish the following with respect to derivative transactions:

(1) appropriate limits for various identified risks relevant to the derivative transactions used by the insurer;

(2) procedures and practices that control the nature and amount of such risks;

(3) adequate systems or processes for identifying and measuring such risks;

(4) systems or processes for documenting, monitoring and reporting risk exposures on a timely basis; and

(5) systems or processes of internal review and audit to ensure the integrity of the overall risk management process.

(b) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive and review quarterly reports which shall include: information to ascertain that all derivative transactions have been made in accordance with delegations, standards, limitations and investment objectives contained in the derivative use plan; the outstanding derivative positions; the unrealized gains or losses thereon; the derivative transactions closed during the report period; a performance review of the derivative transactions; an evaluation of the risks and benefits of the derivative transactions; and other information necessary to ensure that the internal control procedures are being followed.

(c) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall establish the following management oversight standards for derivative transactions:

(1) The board of directors, or a committee thereof charged with the responsibility for supervising investments, has an affirmative obligation to inform management of its desired risk tolerance levels. Management shall appropriately translate these risk tolerance levels into effective policies and procedures that address both individual transactions and entire portfolios;

(2) Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive sufficient information to assess the strengths and limitations of the insurer's risk measurement systems in order to determine

appropriate risk limits. The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall also review management's response to strengths and limitations identified through oversight processes such as stress testing, independent validation and back-testing of risk measurement models. Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall consider the information identified by the oversight processes, including the potential for indirect effects of downside performance beyond the insurer's finances, when they determine and communicate their risk profile;

(3) When management or the board of directors, or a committee thereof charged with the responsibility for supervising investments, identifies weaknesses in the risk management process, they shall consider alternatives and take steps to strengthen that process;

(4) Actions shall be taken to correct any deficiencies in internal controls relative to derivative transactions, including any deficiencies determined by the independent certified public accountant in the evaluation of accounting procedures and internal controls;

(5) Risk oversight functions shall possess independence, authority, and expertise; and

(6) Issuer and counterparty credit decisions for each transaction shall be consistent with the overall credit standards of the insurer.

Section 178.5 Internal controls and reporting

(a) Before engaging in derivative transactions, an insurer shall establish adequate internal control procedures to deal with derivatives, which shall include but not be limited to:

(1) systems or processes for periodic valuation of derivative transactions including mechanisms for compensating for any lack of independence in valuing trading positions;

(2) systems or processes for determining whether a derivative instrument used for hedging has been effective;

(3) credit risk management systems or processes for over-the-counter derivative transactions that measure credit risk exposure using the counterparty exposure amount and clearly articulated policies for the establishment of collateral arrangements with counterparties,

(4) a determination of whether the insurer has adequate professional personnel, technical expertise and systems to implement and control investment practices involving derivatives;

(5) systems or processes for regular reports to management, segregation of duties and internal review procedures; and

(6) systems or procedures for conducting initial and ongoing legal review of derivative transactions including assessments of contract enforceability.

(b) As set forth in section 1410 (b)(5) of the Insurance Law, an insurer engaging in derivative transactions shall be required to include, as part of the evaluation of accounting procedures and internal controls required to be filed pursuant to section 307 of the Insurance Law, a statement describing the assessment by the independent certified public accountant of the internal controls relative to derivative transactions. The purpose of this part of the evaluation is to assess the adequacy of the internal controls relative to the derivative transactions being conducted by the insurer. Such an assessment shall be made whether or not the derivative transactions are material in relation to the insurer's financial statements. The independent certified public accountant shall issue a report regarding internal controls relative to derivative transactions, whether or not deficiencies in internal controls would lead to a "reportable condition", as that term is used in auditing standards

adhered to by certified public accountants. An assessment in the form of an “agreed upon procedures engagement” or an “attestation engagement”, as those terms are used in auditing standards adhered to by certified public accountants, may be used to meet this requirement. If an “agreed upon procedures engagement” is performed, the procedures used shall be those that management and the independent certified public accountant determine are appropriate to meet the purpose of the assessment as set forth above.

Section 178.6 Documentation and reporting requirements

In accordance with Part 243 of this Title (Regulation 152), the insurer shall maintain documentation and records relating to each derivative transaction including:

- (a) the purpose or purposes of the transaction;
- (b) the assets or liabilities (or portfolios thereof) to which the transaction relates;
- (c) the specific derivative instruments used in the transaction;
- (d) for over-the-counter derivative transactions, the name of the counterparty, and counterparty exposure amount; and
- (e) for exchange-traded derivative instruments, the name of the exchange and the name of the firm handling the trade.

Section 178.7 Accounting standards

An insurer shall account for and report derivative transactions in statements filed pursuant to sections 307(a) and 308(b) of the Insurance Law.

Section 178.8 Qualified counterparty

Section 1410(f)(3)(A) of the Insurance Law defines a "qualified counterparty" as a "qualified broker or dealer" or a "qualified bank" or other counterparty rated AA-/Aa3 or higher by a nationally recognized statistical rating organization (NRSRO) if it is also approved by the superintendent. For that purpose the following NRSROs are deemed approved by the superintendent: Moody's; Standard and Poor's; Fitch IBCA Duff and Phelps; and Thompson Bank Watch.

Section 178.9 Exception from disclosure

If an insurer submitting information under this Part deems such information to be a trade or business secret or which if disclosed would cause substantial injury to the competitive position of the insurer, it may, at the time the information is submitted to the superintendent request that the superintendent except such information from disclosure. Such request shall be determined in accordance with the procedures set forth in section 89(5) of the Public Officers Law and Part 241 of this Title (Regulation 71).

Section 178.10 Expiration

Section 1410 of the Insurance Law, the new law governing derivatives, expires on June 30, 2003 and, if it is not extended, the law governing prior to July 1, 1999 shall again become effective and Part 175 (Rules Governing Bona Fide Hedging Transactions) and Part 177 (Rules Governing Bona Fide Hedging and Income Enhancement Transactions of Authorized Property/Casualty Insurers) of this Title shall again become effective and the provisions of this Part shall be suspended. Until that time, the authority to enter into derivatives under the laws previously governing derivatives and Parts 175 and 177 of this Title shall be suspended.

I, GREGORY V. SERIO, Superintendent of Insurance of the State of New York, do hereby certify that the foregoing are amendments to Regulations 111 (11 NYCRR 175) and 142 (11 NYCRR 177) and a new Regulation 163 (11 NYCRR 178), promulgated by me on October 11, 2001, pursuant to the authority granted by Sections 201, 301, 1401, 1403, 1405, 1407, 1410 and 1413 of the Insurance Law, to be effective upon publication in the State Register.

Pursuant to the provisions of the State Administrative Procedure Act, prior notice of the proposed regulation was published in the State Register on August 8, 2001. No other publication or prior notice is required by statute.

GREGORY V. SERIO
Superintendent of Insurance

October 11, 2001