
2000 Valuation Actuary Symposium

Washington, D.C.

September 14–15, 2000

Session 43PD

New York Regulation 163: Insurer's Derivative Activities

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Summary: In 1999, the State of New York passed Regulation 163, which governs the use of derivatives by insurance entities. The regulation is now in effect and has a far-reaching impact on both domestic and out-of-state insurers desiring to use derivatives in their investment strategy. Before Regulation 163, New York's laws, regulations, and circular letters severely restricted the use of derivatives for companies licensed in the state.

This session provides an overview of Regulation 163, including the limits on different types of derivative activities, the Derivative Use Plan (DUP) required by New York, and the reporting and control requirements. Presenters discuss the requirements for successfully implementing Regulation 163 and the general experience of New York-licensed companies that have filed DUPs with New York.

MR. ANSON J. (JAY) GLACY: The topic we'll discuss is the brand-new New York law on derivatives and its accompanying Regulation 163. I think we have a top-notch panel of experts in the thick of Regulation 163.

I am from Ernst and Young and will be the moderator of this session. At Ernst and Young, I am responsible for capital markets risk management for insurance companies, helping them manage risk on both sides of the balance sheet. The first speaker is Mike Moriarty.

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In October of 1999, Mike was appointed the director of financial solvency strategy at the New York Department. In addition, he oversees development of new initiatives to enhance the financial solvency oversight of licensed insurers in New York. These initiatives include accelerating the trends towards reliance on risk-based analyses, monitoring of risk management by insurers, and coordinating the Department's policy on insurance securitization. Mike also participates in task forces and working groups of the NAIC. He currently represents the New York Department as vice chairman of the NAIC Insurance Securitization Working Group, which is charged with developing a regulatory response to the developments in the securitization of insurance risk. Mike received his B.S. degree in accounting from CUNY and holds an Associate degree in reinsurance and an associate degree in insurance, accounting, and finance from the Insurance Institute of America. He is currently pursuing a Chartered Property and Casualty Underwriter (CPCU) designation.

Tom Workman is the president and chief executive officer at the Life Insurance Council of New York (LICONY). Until September of 1999, he served as Chair of the Insurance Law Department in the Ohio law firm of Bricker and Eckler, based in Columbus. Tom received his B.S. degree in business administration and his J.D. degree from Ohio State University. He has been admitted to the Ohio Bar. He served as legislative counsel to the Association of Ohio Life Insurance Companies from 1973 to 1999. He's a past chair of the Board of Directors of the Federation of Regulatory Counsel and of the Life Insurance Law Committee of the American Bar Association. In addition, he currently is chair of the Insurance Law Section of the Association of Life Insurance Counsel and a trustee of the Griffith Foundation on Insurance Education. Finally, Tom also serves as director of Westfield Companies, a leading regional family of property/casualty insurance companies headquartered in Westfield Center, Ohio.

I'll begin with an overview of Regulation 163 to bring all of us up to speed on what this new regulation is all about. Then I'll turn things over to Mike Moriarty from the Department who will give his views. We will finish up with Tom Workman who will provide the perspective on Regulation 163 from the New York life companies' standpoint.

Let me start off with a brief overview of the regulation. First, the textbook definition of *derivative* is a contract whose value or payoff depends on the movements of some underlying price or index. Essentially, a derivative is an instrument or a contract that derives its value from something else. In the insurance industry, typical derivatives are swaps, swaptions, options, cap contracts, and others. The typical underlyings that you will encounter in the insurance industry are the Standard and Poor's (S&P) 500, the London Interbank Offered Rate (LIBOR) and various points on the Treasury yield curve. Note that Regulation 163 and its governing law do not contemplate embedded derivatives, which are derivative-like features contained in convertible bonds, equity-linked notes, and insurance contracts. So they're off the table, as are collateralized mortgage obligations (CMOs).

In 1999, the legislature in New York passed a new Section to Article 14 of the New York Law, Section 1410. The new section addresses derivative transactions and derivative instruments. The changes to the law were effective July 1, 1999, requiring an involved compliance timetable after that. The new law and its accompanying regulation apply to domestic and foreign insurers and reinsurers licensed to do business in New York. We've seen, and it is no surprise that the *new* New York law and regulation are setting a precedent for other states, like Connecticut, that have followed with a similar law and regulation.

From my perspective, Section 1410 is more in the spirit of a prudent-man approach, as opposed to a pigeon-hole approach. One of the motivations for the new law is to permit more flexibility on the part of insurers in the use of derivatives and hedging activities. A second motivation is to modernize the regulatory machinery controlling derivatives. Third is to establish and apply consistent governance to both life and property/casualty companies in their use of derivative instruments. A final motivation is to loosen onerous restrictions on derivatives usage. For example, equity derivatives previously were prohibited by the state of New York and now they're not. Also, under the new law, derivatives might be used for hedging or for certain limited income generation purposes. The new law requires the Board of Directors, or a duly appointed committee of the Board of Directors, to authorize the usage of derivatives by the insurance company. It requires something brand new, a Derivative Use Plan (DUP), to be developed by

the company and submitted to the Department for approval to enable the company to use derivatives. Finally, a derivative position used for hedging can only be maintained so long as it continues to be effective. In the absence of effectiveness, the position needs to be liquidated, unwound, or sold.

Section 1410(b)(5) of the new law is a controversial section, at least from the standpoint of the Big Five accounting firms, of which I'm a member. This section requires a CPA firm to assess the internal controls of the insurer. There's a lot of controversy now about this section, as accountants and auditors try to understand the level of attestation that it requires. Note that the certain limited income generation that I mentioned before is only permitted for covered calls. Section 1410 specifies aggregate position limits, both in terms of dollars and in terms of counterparty relationships. Finally, the new law authorizes Regulation 163 to establish the content of the DUP, which will be the primary focus of this session.

While the new law is flexible and is consistent with a prudent-man approach to the regulation of derivatives usage, it does enforce some reasonable limits on aggregate positions. The statement value of option-like instruments owned by the insurance company must be less than 7.5% of admitted assets. Option-like instruments, as defined in the law, are derivative contracts that require an up-front outlay. The statement value of option-like instruments written must be less than 3% of admitted assets. Finally, the "potential exposure" of forward-like instruments must be less than 6.5% of admitted assets. Forward-like instruments are ones like forwards, futures, and swaps that don't require an initial outlay on the part of the purchaser. The law has defined this thing called "potential exposure," which, if you analyze it, is about 0.5–1% of the notional amount of these contracts.

There are also aggregate limits on counterparty exposures. Exposure to a single nonqualified entity must be less than 1% of admitted assets. Exposure to all nonqualified entities must be less than 3% of assets. The law exerts no limit on exposure to qualified counterparties. Exposure is defined as the sum of statement value and potential exposure. A qualified counterparty is a registered broker/dealer with net capital greater than \$250 million or a bank-rated AA or above with assets greater than \$5 billion and a total capital ratio of at least 6%.

As I mentioned, Section 1410 of the law empowers the Department to promulgate Regulation 163. Regulation 163 first defines the relevant terms, like potential exposure and qualified counterparties. More importantly, Regulation 163 specifies the content of what a DUP should include. First of all, Regulation 163 requires the Board of Directors or a duly-authorized committee of the Board of Directors to issue a resolution authorizing the use of derivatives by the company. Second, Regulation 163 requires a DUP to include management oversight standards, which enunciate the risk management program, upon which the insurance company has embarked. Third, Regulation 163 requires the DUP to contain internal control procedures, the procedures and practices that surround derivatives transactions, and the controls that the insurance company places on them. Fourth, Regulation 163 requires documentation and reporting requirements to be included in the DUP. These are the particulars surrounding derivatives transactions. Finally, Regulation 163 identifies the appropriate accounting standards for derivatives contracts.

Management oversight standards, as I mentioned, relate to the risk-management program and apparatus that the insurance company has put in place. First of all, these standards establish limits on identified risks as they relate to the usage of derivatives. Second, they establish functional systems for managing risks, involving identification, measurement, and mitigation. Third, these standards spell out the Board of Directors' responsibilities as they relate to derivatives. First, the Board of Directors has responsibility for overseeing the entire risk management process. Second, the Board of Directors is responsible for establishing and enunciating risk tolerances for the company. Third, the Board of Directors has a responsibility to assess strengths and weaknesses in the risk management infrastructure and to take remedial action if it finds weaknesses in said program.

Internal control procedures relate to the procedures and practices surrounding the actual derivative transactions. They contemplate the establishment of an adequate control environment. I've listed the specific elements that Regulation 163 identifies as being the appropriate standards to appear in a DUP. First is valuation machinery for performing the appropriate mark-to-market for the derivative positions. Second is effectiveness testing capability for ensuring that derivative instruments continue to remain effective in their hedging purposes. Third is the assessment of

counterparty exposures and credit risk on over-the-counter (OTC) contracts. Fourth is assurance that people, processes, and systems (the infrastructure) that the company has in place are adequate. Fifth is ongoing reporting capabilities relating to the actual transactions that occur and controls over them. Sixth is appropriate legal authority relating to OTC contract enforceability. Seventh is certified public accountant (CPA) assessment of internal controls.

Finally, Regulation 163 requires a DUP to include transaction-specific documentation covering the purpose for the derivative, what the hedged item is, what the hedging instrument is, and who the counterparty or the exchange is. Regulation 163 also spells out briefly the governing accounting standards for derivatives.

That's a bird's-eye overview of Regulation 163. Let me turn the proceedings over to Mike who will provide a perspective from the Department.

MR. MICHAEL J. MORIARTY: I'm an accountant by trade, but I've worked for the Insurance Department for 20 years. I know how important actuaries are to the insurance profession. I have a three-year-old at home, and I'm trying to convince him to be an actuary. When I put a yellow blanket and a blue blanket in front of him, though, he goes to the yellow blanket, so I think he's going to be a casualty actuary.

What I'd like to do is review the thought process behind the law and the regulation; in other words, what were we thinking when we put this draft together with the help of industry and with the help of the legislature. I'll go over what the regulation calls for in derivative use plans in very broad terms. Jay did a good job of going over a lot of the detail, and I'll try to avoid being redundant. I'm going to describe the department's experience in processing the derivative use plans to date. I see the pros and the cons of the process. Finally, I'm going to wrap it up with what I see happening on a going-forward basis. There are some improvements that we have to make in the regulation and in the processing of the derivative use plans at the Department.

As Jay indicated, the governing statute is Section 1410 of the New York Insurance Law. It's a law that was enacted by the legislature in Albany. We had to go up and lobby the law with the help of industry. In New York and in other states, the law establishes the very broad authority,

and then the Insurance Department promulgates a regulation that goes into some detail in clarifying what is required under the provisions of the law. Regulations are drafted by the Insurance Department and have the full force and the effect of law. They generally leave less leeway for interpretation than a law does, and they can certainly be changed a lot more easily than statute can be changed.

Section 1410 of the law was enacted in July of 1999. It has a transition period whereby companies had until December 31, 1999 to come into compliance with the new law. It's applicable to all property and life insurers. Health insurers in New York are not permitted to use derivatives at this point. Section 1410 establishes the same requirements for a property and casualty company and for a life company and, as Jay indicated, it limits the use of derivatives to hedging or to covered calls for income enhancement. Section 1410 is applicable to domestic and to nondomestic insurers. To nondomestic insurers, both foreign and accredited reinsurers, the law is applicable on a substantial compliance basis. Foreign-licensed insurers, which are insurers domiciled in another state but licensed in New York, can do derivatives not authorized under Section 1410 if they are permitted to do these derivatives under their home state law. However, the insurer must still file a DUP with the New York Department setting forth two things: one is what those derivative transactions are; the second is the statute in its home state that allows the insurer to do those derivatives.

We changed the law for many good reasons. The Department supported the effort to change the law. We drafted the initial law and received feedback from the industry. Then both the Department and the industry went to the legislature together. The Department believes that insurers should be permitted to use derivatives. Derivatives, if used correctly, are a valuable tool for insurance companies. They can be used to hedge risk and to contain cost. Insurers, like other players in the financial services industries, whether banks, investment banks, or securities firms, need the ability to use derivatives on a level playing field with these other players.

With that authority, though, comes a certain amount of responsibility. The law, prior to July 1999 contained some critical deficiencies. There was an inconsistent authority between life and property/casualty (P&C) insurers. If you were a life insurer, you went to a section of Article 14

and had completely different requirements than a P&C company that went to another section in Article 14. The new law remedies this by establishing the exact same requirements for a property or a life company.

The old law had limitations on the types of derivatives insurers were permitted to use. Property and casualty companies were essentially limited to using exchange-traded derivatives. They could not use any over-the-counter derivatives. The new law remedies this by allowing insurance companies to use basically any kind of derivative, whether it be exchange traded or whether it be over the counter, and that's a big change. The over-the-counter derivatives market is growing, and it allows insurance companies a lot of flexibility to develop derivatives that serves their strategy.

There were inappropriate measures of limits on the amount of derivative transactions that can be affected. For example, property and casualty insurers could hedge 15% of their invested assets. It didn't matter what derivative instruments were being used to hedge those assets. They could have been using put options to hedge their equity portfolio. Put options have little risk, other than the risk of losing the premium that you pay for the put options. Conversely, they could be using interest rate futures to hedge interest rate risk. Interest rate futures are much more volatile. The old law did not make any distinction. An insurer could hedge 15% of its assets with whatever derivatives it chose. The new law addresses this by setting different limitations for the broad categories of derivatives that are used in the marketplace.

If you use an option type of derivative, the limitation is based upon the statement value of that option. If forwards, futures or swaps are used, the limitation is based upon a calculation of potential exposure. The latter types of derivatives tend to be more volatile, and potential exposure is a better measurement for regulatory purposes.

Finally, under the old law, there was an inconsistent application to the nondomestic licensed insurance companies. For life insurers, the law only applied to domestic insurers. Foreign insurers did not have to file any notice under the old law, and they were not given any surplus penalty if they used derivatives that were not permitted under the New York law. Conversely, the property and casualty regulations applied to both domestic and foreign insurance companies.

Furthermore, under the old regulation, foreign licensed property and casualty insurers could not use derivatives that were not permitted under New York law, even if the derivatives were permitted under the insurer's domestic state law. We found that position to be unworkable because New York has many large property and casualty insurance companies that were permitted to do a wide range of derivatives under their home state law. The Department was not going to take away their license, especially for some of these big players, just because they were using derivatives that were not permitted under New York law. The new Section 1410 corrects all of these deficiencies to some degree.

Now let me try and go over the thought process in the new law. First of all, it's predicated upon prior approval. Before we allow an insurance company to do derivatives, both the Department and the legislature wanted to be assured that the insurance company has demonstrated that it has the wherewithal to do derivative transactions. Prior approval has pros and cons, which I'll go into later.

Second, the regulatory process established under the law places a very strong reliance on effective corporate governance, on management oversight, and on internal controls. We had talked to the banking regulators at the Federal Reserve and at the Office of the Comptroller Currency (OCC) before we drafted the regulation. It is the banking regulators' perspective that the approach established in the regulation is the most effective way to regulate derivative activities. You can't regulate derivatives on a transaction-by-transaction basis. You can't regulate derivatives on a retrospective basis. So the only means to effectively regulate this is to make sure that the company is establishing prudent oversight standards in their own shop prior to engaging in derivative transactions.

Once the derivative use plan is approved, the Department intends to monitor adherence via limited risk-focused examinations. You want to make sure that what is set forth in the derivative-use plan is being adhered to. This will be a risk-focused examination. Derivative operations will not be looked at in every examination. We will only do it if the volume of derivative activity is material, or if we get a sense that there are problems with the derivative activity. Finally, as Jay alluded to, we will look to a third party review. There is a requirement

under the law that the CPAs look at the internal controls relative to derivative transactions on an annual basis.

Jay went into a lot of what Regulation 163 requires. It expands on the management oversight standards, the internal controls, and the documentation required under the statute. The regulation tries to establish a best-practices type of layout with respect to these three items: the management oversight, the internal controls, and the documentation. Most of what is in the regulation are pretty accepted practices by companies using derivatives. We look for a periodic valuation of derivatives. We look to make sure that the company is managing the effectiveness of the hedge. We look for certain credit risk management policies, so that if you're dealing with counterparties, there are limitations on the counterparties that present the highest risk. You combine this with your other credit risk management when you're buying bonds and other securities. Regular reports to management and a legal review of derivatives to make sure there's enforceability are other standards that are called for. There's nothing in the regulation that the industry objected to in substance.

As Jay indicated, the regulation defines certain terms, and it prescribes the accounting guidance to be used for derivative transactions. With respect to accounting guidance, the Department adopted the NAIC rules on accounting for derivatives, which are set forth in the Codification of Statutory Accounting. This guidance is consistent with accounting used by the other states. That could all change as the NAIC begins to look at the implications of *FAS 133* and how that's going to interact with existing NAIC guidance. Nonetheless, insurance companies in New York will now be required to follow the NAIC guidance.

There are eleven guidelines in Section 178.4B. We look for these eleven guidelines when we review a DUP. I'll go through some of them. The plan should address the type and the diversification of derivative instruments, limitations on counterparty exposure, limitations on the use of derivatives, asset/liability management (ALM) practices with respect to derivative transactions, liquidity needs with respect to derivatives, how they affect the liquidity policy of the insurance company, and the policy objectives of management with respect to derivatives.

In addition, we look for the board of directors or a committee of the board to establish acceptable levels of risk. If the board or the committee sets forth risk measures with respect to a variety of risks, we expect them to be included in the DUP, if these risks are applicable to the derivative operation. Finally, there's a statement of compliance. Basically, the board and the committee affirm that they will comply with the standards of the law.

The DUPs need not follow the format of the regulation. In a certain respect, it was never intended that companies would need to write new derivative use plans in order to comply with Regulation 163. If an insurance company had already addressed all of the issues set forth in the regulation in an existing derivative use plan, in its investment plan or in its practices and procedures, we thought that a company could just pull that up, submit it, and then we could review that. What we found out was that while many of insurance companies had guidelines and practices that effectively would have met the requirements, these practices either were not documented or were not approved by the board or the committee. They were kind of "defacto" practices and procedures. We heard from the companies that they had to rewrite these into a derivative use plan.

All the guidelines should be addressed in the DUP. If the standards are not applicable, this should be set forth in a cover letter, explaining why the standards do not apply. When we look at the DUP, we look for adherence or a mention of the guidelines. Clearly, there are instances where the guidelines are not applicable. For example, the regulation requires that you have a system to value your derivatives. If all you're doing is using exchange-traded covered call options, you do not need an in-house valuation system. Exchange-traded options have a readily accepted market value on a daily basis, and that is an acceptable method of obtaining a valid valuation.

We are trying to be flexible with respect to DUPs, and that has led to some of the problems because companies don't quite know exactly what the Department is looking for. Sometimes they overaddress issues, and many times they try and underaddress issues. They wind up going through a lot of back and forth between the companies and the Department.

With respect to the Department's experience with derivative use plans, we received plans from over 150 insurance companies. To date, only one-third of them either have been approved or have been approved in content and are just waiting for the board or the committee authorization. A dozen or so have been rejected for various reasons. The other more than 80 insurance companies are what I would consider to be in the late stages of review. These DUPs have gone through two rounds of review and are down to a manageable number of issues. We do expect to have all of these initial batches of DUPs reviewed by year-end. As far as the process goes, we're using a combination of internal and external review. We hired a consultant to assist in the review of derivative use plans. That consultant came aboard in March.

As with any endeavor of this magnitude, there are pros and cons. The pros are that insurers are developing derivative use plans and formalizing risk management processes. The Department has not come across a case where there is such a concern about the derivatives operation or the proposed derivatives operation that it is thought to pose a threat to the solvency of the insurance company.

Basically, what we have found, as I alluded to before, is that many companies have not formalized their risk management processes with respect to derivatives. In many cases, they indicate that it's because derivatives are not a material part of their operation. While that might be true, it is our position that it's still prudent to formalize the risk management processes that are applicable to the derivative transactions. We also see some changes to the insurer's processes. In reviewing the standards set forth in the regulation, some insurers are addressing issues they had not addressed before. We've seen many cases where insurers have adopted new practices and procedures with regard to their derivatives operations as a result of the effort to put together a DUP. We see this as a plus to the process.

Certainly, the Department has become more knowledgeable and comfortable with derivative use. Derivatives have a connotation; they are very risky and very complicated. In certain cases, this is in fact true but there are derivative strategies that work to significantly reduce risk. The Department staff members are not experts in derivatives and never have been. We certainly are more comfortable now as we review the derivative use plans. We've interacted with the

companies, and we've interacted with the consultants. We hired a staff person in our capital markets bureau that has a derivatives background. All of this has helped to bring us along the learning curve with respect to derivatives. That's a plus to this process.

We feel the process fosters a movement towards a risk assessment approach to regulation. New York is clearly moving along this risk assessment approach with respect to not only derivatives, but all operations of an insurance company. We want to move away from what we have done in the past, which is to go into an insurance company every three to five years, stay there for eight months to a year, look at every aspect of the insurance company, and then verify the accuracy of its balance sheet. That process does not provide for a timely report. There's too much of a gap between the as-of-date of the examination and the date the report is actually filed. Finally, we don't have to look at every aspect of an insurance company. What we want to try to do is assess where the risk in insurance company operations lay. We also want to dedicate our resources to assessing how an insurance company manages those risks. At the end of the day, insurance companies that are well run, well managed, and well capitalized should not see the same degree of attention that we give to companies that are not well managed or capitalized. We believe that the only way to do that is through an assessment of their risk management process.

What are the disadvantages of the process? I could probably leave this to Tom, and he would take care of it. We're on the same page. The processing of the derivative use plans takes time, and it might hamper a company's reaction to market conditions. It takes far too much time. Part of that is the result of the law itself. It was enacted in July of 1999, and companies were given until December 31, 1999 to come into compliance. We received 150 DUPs and 130 of them came after November 15th. Clearly, the Department was not able to process that number of derivative-use plans prior to year-end 1999.

The Department has 90 days to review the DUP. It then is sent back to the company with questions and comments. The company has 45 days to get back to the Department with its response. The Department then has another 60 days to review the revised DUP, and to send back another letter to the company if there are more issues. This process extends itself by its very nature. What we found out is that we've been able to expedite the process through meetings with

the companies. You have to sit down with the companies, either face to face or in a conference call, and literally go through the DUPs page by page. We found that these meetings have expedited the review of the DUPs, and that's something that we want to do with all companies.

The nature of the review tends to lengthen the time between submission and approval. Most DUPs are anywhere from 30 pages to 50 pages in length. If you review them, you're going to have questions. So there has to be interaction. That factor, in and of itself, is going to extend a review of the derivative use plan. It's not like a checklist or a cookie-cutter type of regulation. By its very nature, it requires interaction with the company to understand what's going on.

Finally, what delayed the review of the initial DUPs were some operational difficulties. The consultant did not come on board until March. We started the review of DUPs in the fall of 1999, and there was a learning curve at our end. We set best practices in the regulation, and companies have different ways of managing their risk. On our part, there was a learning curve involved in trying to understand what companies were doing. All of these extended the review of these DUPs.

As I just alluded to, there is some uncertainty as to what should be embodied in the DUP. Granted, it sets best practices, but, again, the level of detail the company has to put in the DUP is the bone of contention. Some companies just want to indicate in the DUP that they comply with the regulation. The Department wants more than that, but exactly how much more is the issue. There is some uncertainty as to what the regulation and the law require. I think that has to be examined as we go forward.

There will be an expansion of the derivative authority. When we submitted the original legislation, we wanted companies to do hedging, income enhancement, and replications of asset positions. The legislature, in 1988 and 1999, was not comfortable with the replication authority. They took it out of the bill. It was resubmitted in 2000, and it has passed both the assembly and the senate. It is awaiting the governor's signature. The governor needs to sign the legislation and, 90 days subsequent to that, insurance companies in New York will be able to use derivatives to replicate asset positions. The Department supports this additional authority. Other financial

services firms are using derivatives in this manner. Insurance companies should be allowed to do so also.

We're trying to have more flexibility in both the content of the DUPs and in the way we process the DUPs. Perhaps, we have to get more guidance. It might be more specificity as to minimum standards that we will look for in the DUPs, or, to a certain extent, acceptance of the companies' contention that they have practices and procedures in place. Or maybe insurers should be permitted to cross-reference certain practices and procedures in the DUP rather than copying the whole thing into the DUP.

Let's discuss the process. We have to speed it up. That's a given. One thing that I ran past Tom, and we had talked about it in the Department, was to use a file-and-use system for companies that are amending DUPs that have already been approved by the Department. In other words, say you file your amendment to the DUP. It effectively becomes approved as we review it. We think that's probably something that we want to do and something the industry would want to do. Again, it would just allow a company to react to market conditions on a more flexible basis.

As I indicated before, we will be doing risk-focused exams to try to assess compliance with DUPs, but only in those cases, where the derivative use is material or where we get a hint that something is awry. We're looking for enhanced risk management by insurance companies on an overall basis. Not just with derivatives, but with all of their other operations. With enhanced risk management will come a corresponding shift of regulatory focus away from the balance sheet verification to assessment of risk management. Companies that manage and measure their risk well are less likely to run into financial difficulty.

I hope that I have imparted some of the essentials of the Department's thinking. We do encourage interaction with the department and, if you have any questions on the derivative use plans, or anybody in your company has questions, feel free to pick up the phone. We feel that's the most effective way to get things done.

I'll turn the discussion over to Tom, who will give some of the New York life insurance industry's experience with DUPs.

MR. THOMAS E. WORKMAN: I wanted to begin by saying that I am by no means an expert on derivatives. I would like to tell a brief story.

After Jay asked me to give the New York life industry's views of this process regarding DUPs, it occurred to me that our son had just taken a job with an investment banking firm in New York. I thought, "Gee! Maybe he could tell me what these things are." In fact, I discovered that he is actually assigned to an area of the firm that sells derivatives. I thought, "Boy! This is great. Now I will be able to really know what I am talking about." So one evening, I said to him, "It would be great if you could explain what these things are." And he said, "Dad, I've got something that I think will help. I don't really have time to get into it right now." And I said, "That's okay." The next morning, I discovered a CD-ROM sitting on my desk with the title "Derivatives." That was his explanation! I have to admit that I never opened it. So now you know the extent of my formal education on the subject!

I have had enough conversations with some of our member companies to develop a sense of their experience with the derivative-use plan approval process in New York during 2000. First, I want to state a couple of obvious things. Our member companies strongly support the proper use of derivatives. Of course, this whole subject of derivatives received some very bad press in Los Angeles several years ago and in some other places. It became a real public issue for many regulators, not only in the insurance area, but in other areas of business as well. In addition, we certainly do support and did support the legislative effort undertaken in New York by the Insurance Department. In many respects, derivatives are complex, sophisticated instruments, and there are an ever-increasing number of types of them. It makes managing them very challenging.

As Mike has indicated in his remarks, the derivative use plan approval procedure in New York has been a very long and involved process. I think one of our companies said "incredibly" long. The truth is that it was a very lengthy process. A number of companies actually filed their plans ten months ago, and are only now beginning to see "light at the end of the tunnel." I think part of

that is what has been reported to me by some of our companies. While the regulation contains a lot of detail and a lot of specific requirements, there is not one uniform format or framework, for the plans.

Because companies are different, they have different viewpoints, different investment strategies, different uses for derivatives and an interest in different kinds of derivatives. For all of these reasons, there did not seem to be a one-size-fits-all approach. Certainly, from the regulatory standpoint, the Department was wanting to be fair and wanting to treat all the companies in a balanced and uniform way. That is just very hard to do when you have variety in the marketplace and in the products offered, as well as among the companies that are using derivatives. There were certain issues constantly brought to the attention of our companies as their representatives met with the Department. They wanted to know how much detail is needed in the plan.

Mike discussed approval by company boards. Most of the time, issues that are brought to a company board are more general in nature, more fundamental in description and type and content. So the kind of detail that our companies were asked to put in their plans and seek board approval of just seem to be out of the ordinary—well beyond what is normally taken to a company board.

I had one company representative that I spoke with at some length about this who said, “You know, we really use derivatives only for defensive purposes. Over this past year, we have worked with the Department and we have been able to come up with a plan that is a little less complex. Nevertheless, the Department has still wanted us to address all of the forms and uses of derivatives in our plan and not just concentrate exclusively on the one or two that we are currently interested in.” The Department was, in fact, seeing these different approaches, and it was constantly raising the issue of what is the preferred approach and the solution. That leads us to the term that Mike used. There really was a steep “learning curve” for the companies, as well as the Department, as they tried to apply the new derivative use plan law and regulation.

Initially, our companies found that the Department was attempting to resolve the issues in the proposed plan exclusively in writing. They wanted a complete paper trail of all the related issues

so that nothing was lost in the translation. That made sense to everyone in the beginning, but with the level of complexity and the volume of work involved, that just did not work. As Mike has indicated, ultimately, they concluded that they had to have face-to-face sessions between company and Department representatives, so that they could, more expeditiously, resolve particular issues. Accordingly, the turnaround time on these issues has reduced measurably, and I think that has a lot to do with having improved procedures in place and a higher level of sophistication between both the industry and Department representatives involved.

The real objective seemed to be, and we believe it is, an attempt at having checks and balances on both sides so that there is a built-in system and real protection from inappropriate use of these instruments. The fundamental questions were quite specific. Who at the company handles the transactions? Who makes sure that there is adequate authority for those persons to act? Who controls the dollars and to whom do those individuals report? The answers to all of these questions flow from the authority of the board.

I wanted to emphasize another point here, and that's one that Mike, again, just mentioned. We are very pleased to hear him speak about the Department considering the possibility of adopting a file-and-use approach to amendments to DUPs. In fact, I had another company say that one of their great struggles, as they drafted their plan, was to draft it in a way that was flexible enough, general enough, and possessing a big-picture perspective to accommodate necessary secondary changes that are required from time to time. They imagine the nightmare of thinking, "Gee! If we tighten the screws down on this plan too tightly, do we have to go back through this approval process every time we have to make the slightest change in the plan?" It just will not work. The system will break down. We cannot spend six months or ten months getting approval for secondary amendments. So this idea of a file-and-use approach is very, very attractive to us.

Another point that was related to me is that this is a matter that requires board approval of the derivative use plan before it is filed with the Department (after the Department approves the plan). From the standpoint of our companies, the sense of it is that having board approval of a draft plan at the beginning, before it has actually been approved and worked through with the department, is really duplicative and unnecessarily time consuming. Any issue that is brought

before a board has to be very well staffed and well thought out. There is a great deal of work involved just in preparing any matter for presentation to a company board. The idea of having to do that and knowing that the document that we are working with is really not the one that we will ultimately end up having to get approved. It seems to be an unnecessary extra step in the process. Logically, it ought to be something that management puts together and gets reviewed by an executive committee of the board in a draft form. We then work it out with the Department and come back with a final recommended plan.

On another front, there is a lot of repetition in the plans in terms of the verbiage used because it seems, from the Department staff's standpoint, they want to have all the words that apply to a given provision in that provision and not incorporated by reference. When you are drafting it, it seems redundant but, in fact, it is something that has been required.

As far as the issue of changing the regulation is concerned, I think, at this point, there is no desire on the part of the life industry to seek such changes. When I asked some of our member companies about the possibility of changing the regulation, I received this response, "We have been working on this for so long, now we think we know the meaning of the existing regulation. The last thing we need is changes to this regulation. The Department has a comfort level with the regulation as does the industry. As onerous as it may be, it is there, so let's not tinker with it. Let's just leave it where it is and rely on the understandings that we have worked out."

That really summarizes the reactions that I received from our companies as I met with them to discuss this process.

MR. GLACY: Thank you, Tom. Since we have a few minutes for questions, let me start off by asking Mike about the 12 companies that had their DUPs rejected.

MR. MORIARITY: Some of the companies were not doing derivatives and did not need to file a DUP. Other companies were doing a limited amount of derivatives. What we're trying to do at this point is to get all the DUPs that we have on file processed. We'll look into and take appropriate action with the companies that are doing derivatives and, for whatever reason,

haven't filed DUPs. Again, we're less concerned with disciplinary action than with dealing with the companies that are trying to comply before we look again to see what other companies are doing.

MR. PHILIP A. EISENBERG: Mike, you mentioned something about wanting to get away from an 18-month review of companies. I took that to mean quinquennial examinations. Does that relate just to derivatives or is there some overall change going on with triennials?

MR. MORIARITY: The Department would like to get away from triennials. We probably spend too much time at companies with which we don't have a lot of difficulty from a financial perspective. I'm not commenting on the market conduct side of it. But I'm fairly comfortable with highly rated companies that have clean CPA reports and that have rating agency reports. You get a fairly good sense that there's not a lot of financial difficulty with respect to those companies. There's no need for us to go in and verify an entire balance sheet when the balance sheet is presented fairly. We've spent a lot of time at the company and the company has spent a lot of time with the examiners. So what we'd like to try to do is limit the scope of our examination greatly and focus on those areas where we can identify risk. That is a doable process, but it might take some time. To a certain extent, it might even require some statutory change, but it's where the NAIC is heading, because we're planting the seed. This is a banking approach. The banking regulators shifted to this risk assessment approach in the mid 1990s, and it makes a lot of sense to us. Because of financial modernization, the Federal Reserve will be the umbrella regulator of the holding companies, and they're going to look for this type of analysis. So we are looking at it more broadly than we look at derivatives.

MR. EISENBERG: In terms of the process for the DUP approvals, I'm not sure where this fits in the Department. I see your title relates to financial solvency, but how are actuaries involved in the process?

MR. MORIARITY: Each DUP is processed by the life or the property bureau. Our actuaries are based in Albany and they haven't been involved in the review of the DUPs to any great deal. I want them involved. Derivatives usage is one piece of the overall investment strategy and the

ALM strategy. To accurately look at them on an adherence basis, we have to get our actuaries involved because they are our ALM experts with respect to our life insurance companies.

MR. JOHN A. GMELCH: I have a question with respect to position limits. It would seem that with higher limits for purchased options rather than written options (specifically covered calls), it reflects the view that buying an option is less risky than selling one. To me, if I've bought an option from someone he might end up owing me a lot of money. I'm more worried about that than if he paid me. I have to make good on that at some point in the future. So I wanted to get a sense of what the thinking process was in terms of the position limits on those kinds of transactions.

MR. MORIARITY: Under limitations of the law, the legislation is limited to hedging transactions on covered calls, which are fairly safe transactions. Why should there be a limitation if you're hedging risk? In theory, if you want to use derivatives, the more risk you hedge the better it is. It should be less of a problem to us. With respect to covered calls, the only thing a company is losing is the upside of the underlying—the equity or the bond that is being covered. The limitations in the law are taken from the NAIC model law. There does not appear to be any quantitative analysis as to why these are prudent limitations. When the NAIC was developing these limitations, regulators felt there had to be some limit. The legislature feels the same way, too. If you limit it, you reduce the risk of something going wrong. Again, there is no empirical evidence that these limitations are prudent or that they mean anything. If you purchase an option, the most you're going to lose is your premium. But you're right; there is credit risk there. Although, if you write an option, you could have unlimited losses.

When we look at the DUPs, we look for other measures in the company because, nine times out of ten, the companies set other limitations that are different than what's contained in the model legislation. These limitations often make more sense because they take into account credit risk. They take into account some of the sophisticated value-at-risk limitations and other types of quantitative limitations. We like those in the plans. Intuitively, it just sounded like there was less risk when you purchase an option than when you write an option. But there really is no science behind that at all.

MR. GMELCH: From a practical point of view, it probably won't make a whole lot of difference. As much as I would love to buy and sell options with insurance companies without limit, my own credit officer is not going to let me buy more than 3% of the company's assets. As a matter of fact, when we're evaluating a transaction internally, we're going to project forward what it might look like five or ten years from now, depending on the tenor. We will examine it from that point of view. So, if you were comfortable with a \$1 billion transaction, that might limit it to a \$100 million transaction today because you're looking at where it is at maturity and at every point in the life of the transaction.

MR. MORIARITY: That's the type of analysis we look to the insurance companies to do with their counterparties also. With respect to the limits, I get the sense that most companies are comfortable that the limitations will allow them to do as much derivatives as they want to do.

MR. GMELCH: Now that replication transactions are being contemplated in New York, what kind of things are we looking at in terms of risk-based capital?

MR. MORIARITY: The RBC formula on the life side was changed and is effective in 2001. So for whatever asset you're replicating, you get the charge with respect to that asset being replicated in the RBC formula. I think the property/casualty RBC working group is also looking at a similar change to their formula. Larry Gorski of Illinois is leading an effort to monitor replication on an ongoing basis to determine its effect on the RBC because that's a big concern. You want to make sure that capital is being held to support these derivatives that are replicating assets or liability positions.

MR. GMELCH: Will it be intended to reflect both the underlying asset as well as counterparty risk?

MR. MORIARITY: That's correct.