

State Corporation Commission 2011 Fiscal Impact Statement

1. Bill Number: HB1504

House of Origin Introduced Substitute Engrossed
Second House In Committee Substitute Enrolled

2. Patron: Ware, R.L.

3. Committee: Passed Both Houses

4. Title: Insurance companies; investments in derivative transactions, etc.

5. Summary/Purpose: Sets forth criteria to be met by Virginia domiciled (domestic) insurers in order to engage in hedging and replication transactions involving derivative instruments. Adds definitions for cap, cash equivalents, collar, counterparty exposure amount, derivative instrument, derivative transaction, floor, forward, future, hedging transaction, insurance future, insurance futures option, option, over-the-counter derivative instrument, potential exposure, qualified clearinghouse, qualified exchange, qualified foreign exchange, replication transaction, statement value, swap, underlying interest, and warrant. Clarifies that “assessment” does not include ordinary contractual payments or the transfer of collateral or margin made under a derivative instrument pursuant to § 38.2-1428. Sets forth the general conditions required for domestic insurers to engage in derivative transactions. Provides that derivative instruments may be used to engage in hedging and replication transactions. Requires each domestic insurer utilizing derivative instruments to establish written guidelines regarding the insurer’s objectives for engaging in derivative transactions and strategies. The Commission may require additional details. The insurer’s board of directors or committee is required to approve the guidelines and any amendments, and is required to establish a procedure for reviewing derivative transactions, at least annually, to determine that they have been made in accordance with the guidelines. Prior approval by the Commission of the guidelines and any amendments is required. The Commission has 90 days to provide written approval of the guidelines or to request additional information, and 60 days to provide written approval of any amendments or to request additional information. If the Commission has not approved the guidelines or amendments, or requested any additional information within these timeframes, the guidelines will be deemed approved after 90 days and the amendments will be deemed approved after 60 days. Authorizes the Commission to establish rules and regulations regarding derivative transactions, which may include financial solvency standards, valuation standards, and reporting requirements. The current provisions in subsection B regarding hedging transactions are deleted. New provisions require the domestic insurer to demonstrate to the Commission the ongoing effectiveness of the derivative transaction(s) through the use of cash flow testing or other analysis, and sets forth limits on: (1) the aggregate statement value of options, caps, floors, and warrants not attached to another financial instrument used in hedging transactions (not to exceed 7.5% of its admitted assets), (2) the aggregate statement value of options, caps, and floors written in hedging transactions (not to exceed 3% of its admitted assets), and (3) the aggregate potential exposure of collars, swap,

forwards and futures used in hedging transactions (not to exceed 6.5% of its admitted assets). Allows domestic insurers to enter into replication transactions if the asset being replicated would comply with the investment requirements of Article 2 (Category 1 Investments). The aggregate statement value of all replicated assets shall not exceed 10 % of admitted assets. Provides that the counterparty exposure amount is deemed an obligation of the business entity to which the insurer is exposed to credit risk in order to determine compliance with §§ 38.2-1411.2 and 38.2-1413. Authorizes the Commission, pursuant to rules promulgated under § 38.2-223, to approve the use of additional derivative transactions that are in excess of the limits set forth in § 38.2-1428 or for other risk management purposes. Adds definitions for actual direct compensatory damages, commodity contract, contractual right, netting agreement, and qualified financial contract (provides the Commission with discretion to determine if any similar agreement may be considered a qualified financial contract for purposes of Chapter 15). The definitions for forward contract, repurchase agreement, securities contract, and swap agreement are as defined in 12 U.S.C. § 1821 (e) (8) (D). Provides that no person shall be prohibited from exercising certain rights regardless of any other provisions in Chapter 15. These rights include: (1) the contractual right to terminate obligations in connection with any netting agreement or qualified financial contract with an insurer, (i) regardless of the insolvency, financial condition or default of the insurer, as long as the right is enforceable under other laws, or (ii) the commencement of delinquency proceedings under Chapter 15; (2) any right under certain agreements relating to one or more netting agreements or qualified financial contracts; (3) the right to set off or net out any termination value, payment amount or other transfer obligation in connection with one or more qualified financial contracts under certain circumstances; or (4) the right to claim damages if a counterparty to a master netting agreement or a qualified financial contract with an insurer terminates the agreement or contract (the amount of the claim for damages shall be the actual direct compensatory damages). Sets forth the requirements for a nondefaulting party to transfer the net or settlement amount of a netting agreement or qualified financial contract to an insurer upon termination of such agreement or contract. Such property or amount shall be considered a general asset of the insurer. Sets forth the requirements for the receiver to follow in order to transfer the netting agreements or qualified financial contracts of an insurer. The receiver shall either (1) transfer to one party (other than the insurer subject to Chapter 15) all of the netting agreements, qualified financial contracts (including all rights and obligations of each party) and property, or (2) transfer none of the netting agreements or qualified financial contracts. Requires the receiver to use its best effort to notify all parties to netting agreements or qualified financial contracts regarding the transfer of such agreements or contracts, by noon on the business day following the transfer. Provides that the receiver may not void any transfer of money or property in connection with a netting agreement or qualified financial contract that was made before the commencement of a delinquency proceeding under Chapter 15 unless the transfer was made with the intent to hinder, delay or defraud the insurer, receiver, or existing or future creditors. Provides that a receiver shall either (1) disaffirm or repudiate all netting agreements and qualified financial contracts, or (2) disaffirm or repudiate none of such agreements and contracts. Provides that any

claim of a counterparty arising out of a receiver's disaffirmance or repudiation of a netting agreement or qualified financial contract, that is made with a reasonable period after commencement of a delinquency proceeding, shall be allowed or disallowed as if the claim has arisen prior to the date of filing of the petition for liquidation. The amount of the claim shall be actual direct compensatory damages. Provides that this section shall not apply to affiliates of the insurer. Provides that counterparty rights shall apply to netting agreements and qualified financial contracts entered into on behalf of the general account, and any separate account in which the netting agreements and qualified financial contracts were entered into on behalf of such separate account and the assets of such account are only available to the counterparties to such netting agreements and qualified financial contracts. According to the second enactment clause, a domestic insurer utilizing derivative instruments prior to the effective date of this act shall be permitted to continue to utilize such derivative instruments during the period from the effective date of this act until completion of the State Corporation Commission's review of guidelines as described in subdivision A 2 of § 38.2-1428 of the Code of Virginia, provided that (i) the domestic insurer reasonably believes that its continued usage of derivative instruments is consistent with § 38.2-1428 and (ii) the insurer submitted the guidelines to the State Corporation Commission for review by April 1, 2011.

6. Budget amendment necessary: No

7. Fiscal Impact Estimates: No Fiscal Impact on the State Corporation Commission

8. Fiscal implications: None on the State Corporation Commission

9. Specific agency or political subdivisions affected: State Corporation Commission Bureau of Insurance

10. Technical amendment necessary: No

11. Other comments: House Bill 1504 was introduced by its patron in response to the passage of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which requires certain financial entities to use exchange-traded derivative contracts. These contracts are standardized as opposed to the over-the-counter derivatives, which allow for customization of contracts. Over-the-counter derivative contracts are privately negotiated and traded between two parties, which allows for the customization of derivative contracts to address the unique risks of insurers. In effect, insurers would not be able to offer certain insurance products if they were unable to hedge their financial risks with derivatives. Interested parties sought state-specific regulation of these over-the-counter derivative contracts so as not to be subject to the Dodd-Frank Act.

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Senate Bill 1319 appears to be a duplicate.

Date: 02/21/11/V. Tompkins
cc: Secretary of Commerce and Trade
Secretary of Health and Human Resources