

DEPARTMENT OF INSURANCE
OFFICE OF THE COMMISSIONER

Statutory Authority: 18 Delaware Code, Sections 311 and 1333 (18 **Del.C.** §§311 and 1333)

PROPOSED

PUBLIC NOTICE

404 Derivative Instruments

INSURANCE COMMISSIONER KAREN WELDIN STEWART hereby gives notice of proposed Department of Insurance Regulation 404 relating to Derivative Instruments. The docket number for this proposed regulation is 2401.

The proposed regulation sets standards for the prudent use of derivative instruments by domestic insurers. The Delaware Code authority for this proposed regulation is 18 **Del.C.** §§311 and 1333 and 29 **Del.C.** Ch. 101.

The Department of Insurance does not plan to hold a public hearing on the proposed regulation. The proposed regulation appears below and can also be viewed at the Delaware Insurance Commissioner's website at <http://www.delawareinsurance.gov/departments/documents/ProposedRegs/>.

Any person can file written comments, suggestions, briefs, and compilations of data or other materials concerning the proposed regulation. Any written submission in response to this notice and relevant to the proposed regulation must be received by the Department of Insurance no later than 4:30 p.m. EST, Tuesday, September 30, 2014. Any such requests should be directed to:

Regulatory Specialist Rhonda West
Delaware Department of Insurance
841 Silver Lake Boulevard
Dover, DE 19904
Phone: (302) 674-7379
Fax: (302) 739-5566
Email: rhonda.west@state.de.us

404 Derivative Instruments

1.0 Authority

This regulation is adopted by the Commissioner pursuant to the authority granted by 18 **Del.C.** §§311 and 1333 and is promulgated in accordance with 29 **Del.C.** Ch. 101.

2.0 Definitions

The following words and terms, when used in this regulation, shall have the following meaning unless the context clearly indicates otherwise:

"**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.

"**Cap**" means an agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

"**Collar**" means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor.

"**Counterparty exposure**" means the net amount of credit risk attributable to an over-the-counter derivative instrument determined as follows:

- (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 SVO 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.

"Credit rating" means with respect to a party or entity, the rating currently assigned to its unsecured and unsubordinated long-term debt, an issuer rating, financial strength rating or other similar rating which assesses the creditworthiness of a party to meet its financial or deposit obligations.

"Derivative instrument" means an agreement, instrument or a series or combination thereof: (a) to make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or (b) that has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests or is dependent on the occurrence or nonoccurrence of any event associated with one or more potential financial, economic, or commercial consequences. The term "derivative instrument" includes, without limitation, options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, swaptions, forwards, futures and any other agreements or instruments substantially similar thereto or any series or combination thereof. The term "derivative instrument" does not include other categories of investments specifically authorized under 18 Del.C. Chapter 13.

"Derivative transaction" means a transaction involving the use of one or more derivative instruments.

"Derivatives clearinghouse" means a derivatives clearing organization registered with the Commodity Futures Trading Commission or the Securities Exchange Commission or regulated, supervised and examined by a foreign regulatory authority.

"Floor" means an agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance or value of one or more underlying interests.

"Foreign regulatory authority" means any foreign (non-United States) government, or any department, agency, governmental body, or regulatory organization empowered by a foreign government to administer or enforce a law, rule, or regulation as it relates to a derivative instrument matter, or any department or agency of a political subdivision of a foreign government empowered to administer or enforce a law, rule, or regulation as it relates to a derivative instrument matter.

"Forward" means an agreement (other than a future) to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance or value of such underlying interests, but shall not mean or include spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

"Future" means an agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more underlying interests.

"Hedging transaction" is a derivative transaction which is entered into and maintained to manage or reduce:

- (1) The risk of change in the value, yield, price, cash flow or quantity of assets or liabilities which the insurer has acquired or incurred or anticipates acquiring or incurring, or;
- (2) The currency exchange rate risk or the degree of exposure as to assets or liabilities which an insurer has acquired or incurred or anticipates acquiring or incurring.

"Income generation transaction" is a transaction involving a derivative instrument set forth in Section 6.0 of this regulation that is intended to generate income or enhance return. Other types of derivative instruments may not be used in income generation transactions.

"Option" means an agreement giving the buyer the right but not the obligation to buy or receive (a "call option"), sell or deliver (a "put option"), enter into, extend or terminate or effect a cash settlement based on the actual or expected price, spread, level, performance or value of one or more underlying interests.

"Over-the-counter derivative instrument" means a derivative instrument the use of which is authorized under this regulation other than a derivative instrument (i) cleared through a U.S. or foreign derivatives clearinghouse or (ii) traded on or through a U.S. or foreign exchange.

"Potential exposure" means 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% x notional amount x square root of

(remaining years to maturity). For futures, the potential exposure = (initial margin per contract on the valuation date, set by the exchange on which contract trades) x (the number of contracts open on the valuation date).

"Qualified counterparty" means a counterparty:

- (1) Which has a designation of "1" or "2" by the SVO, or an investment grade credit rating from at least one nationally recognized statistical rating organization; and
- (2) With which the insurer has entered into a master agreement, together with a credit support annex or other documentation providing for the collateralization of the counterparty's obligations to the insurer under the master agreement, if that collateral documentation provides for (i) daily margin and collateral settlement, (ii) a minimum transfer amount of no more than one million dollars, and (iii) a requirement that collateral be provided by the counterparty from the first dollar of exposure, subject to the minimum transfer amount. For this purpose "minimum transfer amount" means an amount below which a daily margin and collateral settlement is not required.

"Replication (synthetic asset) transaction" means a derivative transaction entered into in conjunction with other permissible investments under 18 **Del.C.** Chapter 13 in order to reproduce the investment characteristics of investments otherwise permissible under 18 **Del.C.** Chapter 13. A derivative transaction entered into by an insurer as a hedging transaction or income generation transaction shall not be considered a replication (synthetic asset) transaction.

"SVO" means the Securities Valuation Office of the National Association of Insurance Commissioners or any successor office established by the National Association of Insurance Commissioners.

"Swap" means an agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance or value of one or more underlying interests.

"Swaption" means an option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

"Underlying interest" means the assets, liabilities, other interests or a combination thereof underlying a derivative instrument, such as any one or more securities, currencies, rates, indices, commodities or derivative instruments.

3.0 Purpose

The purpose of this regulation is to set standards for the prudent use of derivative instruments by domestic insurers under 18 **Del.C.** Chapter 13.

4.0 Permitted Usage

4.1 Insurers may utilize derivative instruments for the following purposes:

- 4.1.1 Hedging transactions, as defined in Section 2.0 and to the extent permitted by Section 5.0 of this regulation;
- 4.1.2 Income generation transactions, as defined in Section 2.0 and to the extent permitted by Section 6.0 of this regulation; and
- 4.1.3 Replication (synthetic asset) transactions, as defined in Section 2.0 and to the extent permitted by Section 7.0 of this regulation.

4.2 A derivative instrument that complies with this regulation is an eligible investment and does not need to otherwise qualify under another provision of 18 **Del.C.** Chapter 13. Derivative instruments shall not be included as miscellaneous investments for purposes of 18 **Del.C.** §1320.

5.0 Limitations on Hedging Transactions

5.1 An insurer may use derivative instruments for hedging transactions under this regulation if, as a result of and after giving effect to the transaction:

- 5.1.1 The aggregate statement value of options, swaptions, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;
- 5.1.2 The aggregate statement value of options, swaptions, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and
- 5.1.3 The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

5.2 Hedging transactions entered into to hedge currency risk of investments denominated in a currency other than United States dollars shall not be included in the above limits.

- 5.3 An insurer may purchase or sell one or more derivative instruments to offset, in whole or in part, any derivative instrument previously purchased or sold without regard to the above limits.
- 5.4 If an insurer holds one or more derivative instruments used for hedging transactions that complied with the applicable limit set forth in Section 5.1 of this regulation at the time that they were acquired, but that have subsequently exceeded such limit, the insurer shall provide written notice to the Department, (i) if such limit is exceeded by an amount greater than 1% of admitted assets, within 10 days of exceeding such limit, or (ii) if such limit is exceeded by an amount less than or equal to 1% of admitted assets, within 30 days of exceeding such limit. Derivative instruments used for hedging purposes that were acquired in compliance with this regulation need not be divested by an insurer if they exceed the limits set forth in Section 5.1 of this regulation. In the event that such insurer desires to engage in additional hedging transactions while such limit has been exceeded, the insurer may request a waiver in accordance with Section 12.1 of this regulation. No further hedging transactions subject to such exceeded limit may be entered into without such waiver.

6.0 Limitations on Income Generation Transactions

- 6.1 An insurer may enter into the following types of income generation transactions:
- 6.1.1 Sales of covered call options on (i) non-callable fixed income securities, (ii) callable fixed income securities if the option expires by its terms prior to the end of the non-callable period, (iii) derivative instruments based on fixed income securities, or (iv) equity securities;
- 6.1.2 Sales of covered put options on investments that the insurer is permitted to acquire under 18 Del.C. Chapter 13; and
- 6.1.3 Sales of covered caps or floors.
- 6.2 For purposes of this Section 6.0, the term "covered" means that an insurer (i) owns or can immediately acquire, through the exercise of options, warrants or conversion rights already owned, the underlying interest in order to fulfill or secure its obligations under a call option it has sold, (ii) holds cash equivalents or segregated cash with a market value equal to the amount required to fulfill its obligations under a put option it has sold, or (iii) holds in its portfolio (A) investments generating the cash flow, or (B) cash equivalents or segregated cash with a market value, in each case, sufficient to make the required payments under a cap or floor it has sold.
- 6.3 In connection with an insurer's income generation transactions under Section 6.1, the sum total of the following items shall not exceed ten percent (10%) of an insurer's admitted assets: (i) the aggregate statement value of the equity or fixed income securities that are subject to covered call options, plus (ii) the aggregate statement value of the assets that generate the cash flows or are sufficient to make the required payments under covered caps and floors, plus (iii) the face value of fixed income securities underlying a derivative instrument subject to a covered call option, plus (iv) the aggregate amount of the purchase obligation under covered put options.
- 6.4 An insurer utilizing income generation transactions must at all times (i) be able to identify on its books and records, without duplication, its ownership of, or right to acquire, the investments, cash or cash equivalents required under Section 6.2 to be held in connection with the income generation transactions authorized under Section 6.1, and (ii) maintain a separate record that (A) lists all of the insurer's outstanding income generation transactions under Section 6.1, and (B) demonstrates how those transactions are "covered" as required under Section 6.2, by the insurer's ownership of, or right to acquire, underlying interests, designated investments, cash or cash equivalents. Such record shall be submitted to the Department upon its request.

7.0 Limitations on Replication (Synthetic Asset) Transactions

- 7.1 Any asset being replicated is subject to all of the provisions and limitations on the making thereof specified in 18 Del.C. Chapter 13 with respect to investments by the insurer as if the replication (synthetic asset) transaction constituted a direct investment by the insurer in the replicated asset.
- 7.2 The aggregate statement value of all assets being replicated shall not exceed ten percent (10%) of the insurer's admitted assets.

8.0 Counterparty Exposure

- 8.1 Counterparty exposure with respect to over-the-counter derivative instruments, other than with respect to a counterparty that is an affiliate of the insurer approved by the Commissioner in accordance with Section 8.2.3 of this regulation, shall be included in determining compliance with any single or aggregate quantitative limitation on investments made by an insurer under 18 Del.C. Chapter 13.
- 8.2 An insurer may enter into a transaction for any over-the-counter derivative instrument only with:
- 8.2.1 A qualified counterparty;

- 8.2.2 A counterparty, other than a qualified counterparty, provided that (1) the aggregate counterparty exposure of the insurer to any single counterparty, other than a qualified counterparty, shall be limited to one percent (1%) of the insurer's admitted assets, and (2) the aggregate counterparty exposure of the insurer to all counterparties, other than qualified counterparties, shall be limited to three percent (3%) of the insurer's admitted assets; or
- 8.2.3 A counterparty that is an affiliate of the insurer, if (a) the Commissioner has approved of the application of 18 **Del.C.** §5933 to such affiliate, in accordance with subsection (h) thereof, or (b) the Commissioner has approved of over-the-counter transactions with such affiliate in accordance with 18 **Del.C.** §5005.
- 8.3 If (i) a counterparty that met the definition of "qualified counterparty" (set forth in Section 2.0 of this regulation) at the time that an insurer entered into a derivative instrument with such counterparty subsequently ceases to satisfy the definition of "qualified counterparty" while such derivative instrument remains in effect, and (ii) as a result of such change in the status of the counterparty, such insurer will exceed the limits set forth in Section 8.2.2 of this regulation, such insurer shall, within 30 days of such change in the status of the counterparty, provide written notice to the Department. Derivative instruments entered into with such counterparty that were acquired in compliance with this regulation need not be divested by an insurer if they exceed the limits set forth in Section 8.2.2 of this regulation. In the event that such insurer desires to enter into additional derivative instruments with such counterparty while such limit has been exceeded, the insurer may request a waiver in accordance with Section 12.1 of this regulation. No further derivative instruments subject to such exceeded limit may be entered into without such waiver.

9.0 Guidelines

- 9.1 Each insurer utilizing derivative instruments shall establish written guidelines stating the policy objectives of management, applicable risk constraints and investment limitations, permissible strategies, the relationship of those strategies to the insurer's operations and how such strategies reduce or control the insurer's market risk or otherwise save transaction costs or substitute for investments or liabilities. The insurer's board of directors, or committee thereof charged with the responsibility of overseeing investments, shall approve the written guidelines and any amendment thereto and shall establish a procedure to determine, at least annually, that all derivative transactions were made in accordance with policy objectives, permissible strategies, the insurer's overall investment goals as outlined in its written guidelines, as well as adherence to and compliance with this regulation. The insurer's written guidelines shall address these requirements of the board or investment committee.
- 9.2 Insurers utilizing derivative instruments on or after the effective date of this regulation and prior to April 1, 2015 shall file a copy of such guidelines for informational purposes with the Department no later than April 1, 2015. Each other insurer shall file a copy of such guidelines for informational purposes with the Department prior to the use of any derivative instruments by such insurer. Any subsequent revisions to an insurer's written guidelines shall be filed with the Department as they become effective.

10.0 Documentation Requirements

- 10.1 An insurance company shall maintain documentation and records relating to each derivative transaction, such as:
- 10.1.1 The purpose or purposes of the transaction;
 - 10.1.2 The assets or liabilities to which the transaction relates;
 - 10.1.3 The specific derivative instrument used in the transaction;
 - 10.1.4 For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure; and
 - 10.1.5 For derivative instruments traded on or through an exchange or derivative clearinghouse, the name of the exchange or derivative clearinghouse and the name of the relevant execution and clearing firms.
- 10.2 An insurer utilizing hedging transactions shall have a written methodology for determining whether derivative instruments used for hedging have been effective.
- 10.3 All guidelines and notices submitted by an insurer pursuant to Sections 5.4, 8.3 or 9.0 of this regulation that are in the possession of or control of the Department shall be confidential by law and privileged, shall not be subject to this State's Freedom of Information Act, 29 **Del.C.** §§10001, et. seq., shall not be subject to subpoena, and shall not be subject to discovery or admissible in evidence in any private civil action.

11.0 Accounting and Reporting

Derivative transactions permitted by this regulation shall be accounted for and reported in accordance with the NAIC manuals, including the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and the Annual Statement Instructions Manuals.

12.0 Waiver

The Department may, in its discretion, from time to time waive one or more of the requirements contained in this regulation upon the written request of an insurer and a reasonable showing of the need for such waiver.

13.0 Existing Derivative Instruments

13.1 Notwithstanding any other requirement of this regulation, any particular derivative instrument held by an insurer on the effective date of this regulation which was a legal investment at the time it was made, and which the insurer was legally entitled to possess immediately prior to such date, shall be deemed to be an eligible investment for so long as it is held by such insurer.

13.2 Each insurer shall be permitted to use derivative instruments during the period from the effective date of this regulation until the date it is required to make its first informational filing pursuant to Section 9.2 of this regulation, provided that such insurer reasonably believes that such derivatives use is consistent with this regulation. Thereafter, insurers shall use derivative instruments in accordance with the guidelines filed with the Department pursuant to Section 9.2.

14.0 Severability

If any provision of this regulation or the application of any such provision to any person or circumstance shall be held invalid, the remainder of such provisions, and the application of such provision to any person or circumstance other than those as to which it is held invalid, shall not be affected.

15.0 Effective Date

This regulation shall become effective on November 12, 2014.