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A Bank with an AA-/Aa3 Rating from a Single Rating Agency is Not a Qualified Counterparty Under New York Insurance Law: *General Counsel, New York Insurance Dept. Office Issues Clarifying Opinion*

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As a result of a June 3, 2009, opinion from the Office of the General Counsel (OGC) of the New York Insurance Department, as well as the recent downgrade of many derivatives counterparties, New York-regulated insurance companies, both domestic and foreign, should confirm that they have correctly classified each bank with whom they hold over-the-counter derivatives contracts as a "qualified" or "unqualified" counterparty. This distinction is important since New York Insurance Law imposes tighter limits on the derivatives transactions an insurance company can hold with a "non-qualified" counterparty. If an insurer has misclassified a counterparty as "qualified," it may find that it holds positions in excess of these limits.

Section1410(f)(3) of the New York Insurance Law establishes three separate categories of qualified counterparties, each with its own set of requirements that a counterparty must satisfy to be deemed a "qualified counterparty:" (1) Qualified broker or dealer under §1410(f)(3)(B); (2) qualified bank under §1410(f)(3)(C); and (3) "other qualified counterparty" under §1410(f)(3)(A).

Many banks which do not have the ratings required to meet the "qualified bank" ratings requirements of §1410(f)(3)(C), have argued persuasively to their New York-regulated insurance company clients that by meeting the less restrictive "qualified counterparty" ratings requirements, they are still qualified counterparties under New York Insurance Law. However, in its June opinion, the OGC rejected this argument stating that a bank that did not meet the "qualified bank" ratings requirements of §1410(f)(3)(C) could not in the alternative qualify under the "other counterparty" standard of §1410(f)(3)(A). "To conclude otherwise," the OGC argued, "would effectively read out of the statute the stricter requirement for 'qualified banks.'" Citing Majewski v. Broadalbin-Perth C.S.D., 91 N.Y.2D 577 (1998), the OGC went on to note the following in support of its position: "Under normal rules of statutory construction, an interpretation that renders part or all of a statute without effect, or results in surplusage, should be rejected."

"Qualified Counterparties" Under §1410(f)(3)

"Qualified counterparty" is defined under §1410(f)(3)(A) through §1410(f)(3)(C). Section 1410(f)(3)(A) first states that "a 'qualified counterparty' is a 'qualified broker or dealer' or a 'qualified bank' or other counterparty rated AA-/Aa3 or higher by a nationally recognized statistical rating organization if it is also approved by the superintendent[.]"[1] "Qualified broker or dealer" and "qualified bank" are each then defined under §1410(f)(3)(B) and (C) respectively. The requirement that the outstanding, senior obligations of a qualified bank must be rated AA or higher by at least two independent Nationally Recognized Statistical Ratings Organizations (NRSROs) is found in the definition of "qualified bank," under §1410(f)(3)(D).

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The confusion concerning the definition of "qualified counterparty" and the requirements a counterparty must satisfy to be considered "qualified" under New York Insurance Law centers around the final clause of §1410(f)(3)(A) which states: "or other counterparty rated AA-/Aa3 or higher by a nationally recognized statistical rating organization if it is also approved by the superintendent."

In addition to the "qualified broker or dealer" and "qualified bank" categories of "qualified counterparties" distinctly referred to under §1410(f)(3)(A) and specifically defined under §1410(f)(3)(B) and (C), the "other counterparty" language of §1410(f)(3)(A) somewhat awkwardly but clearly establishes a third "qualified counterparty" category with a separate criterion a counterparty must satisfy to be deemed "qualified." In its June opinion, the OGC acknowledged and referred to this separate category of qualified counterparties without comment.

Under §1410(f)(3)(B) a "qualified broker or dealer" must be (i) organized under the laws of a state; (ii) registered [as a broker/dealer] under the Securities Exchange Act of 1934; and (iii) have net capital in excess of $250 million. Section1410(f)(3)(C) establishes more detailed requirements that a bank must satisfy to be deemed a "qualified counterparty." In addition to the AA or higher ratings by two ratings agencies' requirement, a "qualified bank" must, among other things, (i) be regulated by a U.S. federal or state authority; (ii) have assets in excess of $5 billion; and (iii) have a ratio of primary capital to total assets of at least 5.5 percent and a ratio of total capital to total assets of at least 6 percent.

On the other hand, the "other counterparty" criterion of §1410(f)(3)(A) simply requires a counterparty to be rated AA-/Aa3 or higher by one NRSRO, which is approved by the Superintendent of the New York State Insurance Department (the superintendent). (The "other qualified counterparty" criterion of §1410(f)(3)(A) could be construed to require approval of a counterparty by the superintendent; however, in adopting 11 NYCRR 178.8, which stipulates that for the purpose of §1410(f)(3)(A), "Moody's, Standard and Poor's, Fitch IBCA, Duff and Phelps, and Thompson Bank Watch" are deemed approved by the superintendent, the New York Insurance Department made it clear that the phrase, "if it is also approved by the superintendent" modifies and applies to "nationally recognized statistical rating organizations," not the counterparty.)

Restrictions on Transactions with Non-Qualified Counterparties Under §1410(f)

Unless an insurance company is trading with a qualified bank (and these days, few banks have outstanding senior obligations rated AA or higher by two ratings agencies) under §1410(f)(2)(A), its outstanding derivatives transactions with any one non-qualified bank or other non-qualified counterparty may not exceed 1 percent of the insurer's admitted assets; and its aggregate transactions with all non-qualified counterparties may not exceed 3 percent of admitted assets.

The calculation of these limits should be based on the percentage of the insurer's admitted assets (as shown on the insurer's last annual statement per §1410(g)), represented by the sum of (i) the statement value of options, swaptions, caps, floors and warrants purchased from non-qualified counterparties (recorded on Schedule DB, Part A, Section 1); and (ii) the potential exposure to non-qualified counterparties under any collars, swaps and forwards (listed on Schedule DB, Part C, Section 1).

Potential exposure is a statistical measure of the possible future credit exposure to a counterparty over time under derivatives instruments, such as collars, swaps and forwards, which generally have no initial market value at inception. Regulation 163.2(l) (11 NRCRR 178.2(l)) directs that potential exposure be calculated with respect to each collar, swap and forward as one half of one percent (0.05%), times the notional amount of the transaction (N), times the square root of the remaining years of its term (t); expressed algebraically as $0.005 * N * \sqrt{t}$. (For example, using this formula, the potential exposure of a $100 million interest rate swap with a remaining term of five years is $1,118,034.)

Limits on Transactions with Qualified Counterparties

In contrast to the 1 percent and 3 percent restrictions on transactions with non-qualified counterparties, the OGC confirmed in its June opinion that §1410 includes no specific limits on "qualified counterparties." However, the OGC went on to point out that §1410(f)(1) requires counterparty exposure under a derivatives instrument to be included in determining compliance with the 10 percent of admitted assets single-entity investment limit under §1409.

Section 1409(a), which addresses aggregate exposure to a single entity under all investments, not just derivatives transactions, directs that an insurer may not have "more than ten percent of its admitted assets as shown by its last statement on file with the superintendent invested in, or loaned upon, the securities (including for this purpose certificates of deposit, partnership interests and other equity interests) of any one institution."

Exposure under derivatives instruments with "qualified counterparties" and "non-qualified counterparties" must be included in determining compliance with the 10 percent single-entity investment limit of §1409, using the same methodology for computing exposure to non-qualified counterparties (e.g., statement value for options, swaptions, caps, floors, and warrants and potential exposure for collars, swaps and forwards).

General Limits on Derivatives Holdings

In addition to counterparty-specific restrictions on derivatives holdings, §1410(c)(1) of the New York Insurance

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Law also imposes limits on the use of derivatives in hedging transactions by life insurance companies:

> (A) Seven and one-half percent (7.5%) of admitted assets limit on the statement value of purchased options, swaptions, caps, floors and warrants;
>
> (B) Three percent (3%) of admitted assets limit on the statement value of written options, swaptions, caps and floors; and
>
> (C) Six and one-half percent (6.5%) of admitted assets limit on the aggregate potential exposure of collars, swaps, forwards and futures; and on aggregate written options swaptions, caps and floors.

Under §1410(c)(2), these limits do not apply to transactions that "effectively hedge the currency risk of investments denominated in a currency other than United States dollars." Section 1410(e) also specifies that these limits will not be applicable to any derivatives transaction entered into for the purpose of offsetting another derivatives transaction, "provided that such derivative transaction is an exact offset to the original derivative instrument being offset."

Calculation of the 7.5 percent and 3 percent limits noted in §1410(c)(1)(A) and (B) is simply a matter of determining what percent of admitted assets is represented by the sum of the statement value of the options, swaptions, caps, floors and warrants purchased or sold by the insurer. On the other hand, measuring compliance with the 6.5 percent limit under §1410(c)(1)(C) is slightly more involved.

The 6.5 percent limit under §1410(c)(1)(C) is based on the percentage of admitted assets represented by the sum of (i) the aggregate potential exposure under all collars, swaps, and forwards calculated using the formula described above; (ii) the aggregate potential exposure under any futures transactions, defined as initial margin per contract on the valuation date (set by the exchange on which the futures contracts are traded) times the number of open contracts; and (iii) the statement value of written options, swaptions, caps and floors.

We provide a summary of these limits in *Exhibit 1*

Collateral Arrangements

It has become customary practice for insurers and their derivatives counterparties to exchange collateral to mitigate mutual credit exposure under outstanding over-the-counter derivatives contracts. Although it may be reasonable to argue that for purposes of compliance with the counterparty exposure limits of §1409 and §1410(f)(2)(A), an insurer's exposure to a counterparty should be reduced by the value of the counterparty's collateral held by the insurer, this issue is not addressed under New York Insurance Law; nor has it been addressed by the New York Insurance Department in any regulations adopted thereunder or other public release. (An argument can also be made that the value of collateral held by an insurer should also be factored into calculations of an insurer's compliance with the derivatives hedging limits of §1410(c)(1), but it would be less persuasive.)

Application of Limits to Foreign Life Insurance Companies Under §1410(k)

For New York-domiciled life insurance companies, the restrictions and limits imposed on derivatives transactions under §1410 are absolute. Derivatives transactions that are prohibited or not otherwise permitted under §1410 may not be entered into under the authority of §1405(8), Other Investments, New York's basket clause.

However, foreign insurers (companies that are licensed but not domiciled in New York) may exceed the requirements of §1410 if (i) the foreign insurer is authorized under the law of its domiciliary state to engage in the derivatives transaction; (ii) the derivatives transaction is covered in the foreign insurer's derivatives use plan (which must be submitted to and approved by, the superintendent); (iii) the transactions are not potentially detrimental to the policyholders or the public of New York (as determined by the superintendent); and (iv) the foreign insurer complies with subsection (a) of §1403, Investments of Foreign Insurers, "after the surplus to policyholders is reduced by" the statement value of options, swaptions, caps, floors and warrants, and the potential exposure of collars, swaps, forwards and futures, not otherwise authorized under §1410.

Section 1403(a), in effect, permits a foreign insurer to make investments not otherwise authorized under New York law if,

> …after disallowing as admitted assets in whole or in part any investments not in compliance therewith, the superintendent finds that such foreign insurer's adjusted surplus to policyholders is not less than an amount which is reasonable in relation to its outstanding liabilities and adequate to its financial needs, and at least equal to the minimum surplus to policyholders required on organization of a domestic insurer to do the same kind or kinds of insurance business.

With respect to the manner in which investments should be disallowed under §1403, in Circular Letter 1958-5 (dated October 17, 1958, with its continued effectiveness confirmed by Circular Letter 2001-1, dated January 22, 2001), the New York Insurance Department specified that for non-qualified investments, the total amount of such investment should be disallowed; and that for investments in excess of prescribed limits, only that portion in excess of the limit should be deducted from the surplus of the foreign insurer for purposes of §1403(a).

As illustrated by the table in *Exhibit 2*, assume a foreign insurance company with $300 million in policyholder

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surplus enters into the following transactions (each transaction is (i) permitted by the domestic law of the insurer's state of domicile; (ii) covered under the insurer's derivatives use plan; and (iii) not deemed by the superintendent to be potentially detrimental to the policyholders or the public of New York):

Under these circumstances, the foreign insurer's surplus would first be reduced by $23,790,569 to $276,209,431 ($3,000,000 statement value of the put option, plus $790,569 potential exposure of the interest rate swap, plus $20,000,000 in excess exposure to non-qualified counterparties). If, after making this adjustment the superintendent determines that the foreign insurer's policyholder surplus is adequate "in relation to its outstanding liabilities and adequate to its financial needs," then the foreign insurer would not be in violation of §1410 or §1403

[1] In its opinion, the OGC clarified that as used under §1410(f)(3)(A), AA-/Aa3 ratings requirement "pertains to the overall rating of the counterparty, in that the statute makes no mention of any specific ratings category."
[2] 11 NRCRR 178.2(1)
[3] Based on hypothetical insurance company with $10 billion in admitted assets as of last reported annual statement

Exhibit 1 - Derivatives Transaction Limits for Domestic Insurers

TEST	CITATION	PERCENTAGE LIMIT	DOLLAR LIMIT[1]
Single Non-Qualified Counterparty Limit	§1410(f)(2)(A)		
Statement value of options, swaptions, caps, floors and warrants *purchased* from a single non-qualified counterparty *plus*		1%	$100 million
Potential exposure of collars, swaps and forwards entered into with a single non-qualified counterparty			
Aggregate Non-Qualified Counterparty Limit	§1410(f)(2)(B)	3%	$300 million
Statement value of options, swaptions, caps, floors and warrants *purchased* from *all* non-qualified counterparties *plus*			
Potential exposure of collars, swaps and forwards entered into with all non-qualified counterparties			
Single Entity Investment Limit (based on aggregate value of all transactions with a single entity, including qualified and non-qualified counterparties)	§1409(a) and §1410(f)(1)	10%	$1 billion
General Limits on Hedging	§1410(c)(1)		
Statement value of *purchased* options, swaptions, caps, floors and warrants	§1410(c)(1)(A)	7.5%	$750 million
Statement value of *sold/written* options, swaptions, caps, floors and warrants	§1410(c)(1)(B)	3%	$300 million
Potential exposure of all collars, swaps, and forwards *plus* statement value of *sold/written* options, swaptions, caps and floors	§1410(c)(1)(C)	6.5%	$650 million

Exhibit 2- Derivatives Transaction Limits for Foreign Insurers

Foreign Insurer Derivatives Transaction	Status	Valuation	
		Statement Value	Potential Exposure
Writes a put option	Not permitted under §1410	$3,000,000	
Interest rate transaction ($50 million notional; remaining term, 10 years) disqualified as hedge	Not permitted under §1410 (i.e., disqualified as hedge and not used in replication transaction)		$790,569
Aggregate statement value of options, swaptions, caps and floors purchased from non-qualified counterparties *plus*	3% of admitted assets limit equals $300 million	$160,000,000	
Aggregate potential exposure of collars, swaps and forwards entered into with non-qualified counterparties			$160,000,000
		$320,000,000	

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