

November 9, 2010

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F St., NE
Washington, D.C. 20549

David A. Stawick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre,
1155 21st Street, NW,
Washington, D.C. 20581

Re: Follow-up to September 29, 2010 Meeting with SEC and CFTC Staff

Dear Ms. Murphy and Mr. Stawick:

We write on behalf of the National Association of Insurance Commissioners (NAIC) to follow-up on our meeting of September 29, 2010 and letter comment submitted on September 20 regarding the definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). At the meeting, staff at the Securities and Exchange Commission and the Commodity Futures Trading Commission (the Commissions) had several questions for the NAIC to consider, and requested certain information from the NAIC to assist them in the rulemaking process.

Definition of “Insurance Contract”

The staff of the Commissions requested the NAIC’s thoughts on the appropriate definition for an insurance contract, presumably for the purpose of considering an exclusion of such contracts from the definitions of swap and security-based swap as is consistent with Congressional intent and required by the McCarran-Ferguson Act of 1945. After careful consideration and consultation with relevant law, we believe an insurance contract constitutes:

1. A contract that exists for a specified period of time;
2. Where one party to the contract (the “insured”) promises to pay one or more payments (the “premium”) to a company licensed by a state to provide such contracts (the “insurer”)
3. In exchange for the insurer’s promise to pay or indemnify the insured or their beneficiary for the loss, destruction, injury or impairment of an identified interest of the insured (the “insurable interest”) as a result of the occurrence of a specified event(s) or contingency(ies); and

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4. Where such indemnification or payment is limited to the extent of the value of the insurable interest.

Excluding contracts that meet this definition would carve out insurance products that are already subject to the robust state regulatory regime while ensuring that the Commissions retain the authority over the swap and derivative products that Congress intended for them to regulate; specifically, the products written and traded in the over-the-counter derivatives market.

Financial Guaranty Insurance

Commission staff requested information about state regulation of financial guaranty insurance. As NAIC staff detailed in the meeting, financial guaranty insurers are subject to stringent state regulatory requirements that include specific accounting, disclosure, reserve and capital requirements. To assist with staff's understanding of such requirements, we forward for your review NAIC's Statement of Statutory Accounting Principles No. 60 (SSAP No. 60) relating to financial guaranty insurance (Exhibit A).¹ SSAP No. 60 sets forth the definition of financial guaranty insurance, which differentiates it from other insurance lines and financial products defined in other SSAPs:

“Financial guaranty insurance provides protection against financial loss as a result of default, changes in interest rate levels, differentials in interest rate levels between markets or products, fluctuations in exchange rates between currencies, inconvertibility of one currency into another, inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental body, changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general. Financial guaranty insurance does not provide protection from losses which occur due to fortuitous physical events, failure or deficiency in the operation of equipment, or the inability to extract natural resources. Additionally, it does not provide coverage from losses related to various types of bonds (e.g., individual or schedule public official bond; a contract bond; a court bond), credit insurance, guaranteed investment contracts, and residual value insurance.”²

SSAP No. 60 also details the disclosure requirements, premium and loss recognition requirements, and contingency reserve requirements for financial guaranty insurance.

As part of the discussion of the financial guaranty insurance business, staff asked for information regarding financial guaranty insurers' use of “transformers” to issue credit default swap contracts that are then insured with the financial guaranty insurance. We have consulted with relevant industry representatives and regulators regarding the use of transformers in the financial guaranty insurance business. Our understanding is that certain financial guaranty insurers have created legally separate affiliates that write credit default swaps (CDS), which are then insured with financial guaranty insurance by a separate state licensed insurance company. While state regulators monitor the insurance company's solvency and have the authority to intervene where necessary to ensure that the financial guaranty insurer is sufficiently capitalized, they do not directly regulate the “transformer,” since it is a separate corporate entity that is not licensed by the state to write insurance. Transactions with these affiliated transformers are subject to regulation under the holding company regulations and must be fair to the interests of the insurer.

¹ Please note that the redline text within the guidance is used by the NAIC to denote the most recent updates to the guidance contained in the document.

² See, SSAP No. 60 at 60-3.

In light of Congressional intent that the Commissions regulate derivatives including credit default swaps, it would be wholly appropriate for the Commissions to regulate transformers' activity in this regard. However, for the reasons set forth both in our letter of September 20 and in our meeting of September 29, we believe it would be wholly inappropriate for the Commissions to regulate the issuance of financial guaranty insurance by state licensed insurance companies.

Financial guaranty insurance is fundamentally different from the credit default swaps and other derivatives that Congress intended the Commissions to regulate. Unlike CDS and other derivative products, financial guaranty insurance is subject to a robust regulatory regime administered by the states. Moreover, financial guaranty insurance insures a specific "insurable interest," such as a bond, from loss upon default by the bond issuer or impairment of the bond as result of a restructuring. The financial guaranty insurer is also only required to compensate the holder of the specific bond for losses that are allocated to that bond as the losses from the underlying assets are determined over time – a fact that is the case even in transactions involving transformers. By comparison, the typical CDS only requires the purchaser of the CDS to deliver any bond issued by the obligor of the reference obligation delineated in the CDS, and purchasers of CDS typically deliver the cheapest bond they can find on the market.

Use of Derivatives by Insurers

NAIC and the Commissions' staff had constructive discussions regarding insurers' use of derivatives and the state investment laws that govern the extent and nature of such use. The Commissions' staff requested that the NAIC provide the specific accounting and risk-based capital guidance for insurers' use of replications. We provide for the Commissions' staff review:

- The NAIC's Annual Statement (Blank) for Schedule DB (Exhibit B), which is the actual disclosure form;
- The NAIC's Annual Statement Instructions for Schedule DB (Exhibit C);
- SSAP No. 86: The Accounting Requirements for Derivative Instruments and Hedging, Income Generation, and Replication Transactions (Exhibit D); and
- Risk-Based Capital (RBC) Formula Instructions and Disclosure Forms for Replications (Exhibit E).³

Part C of both the Annual Statement and the Annual Statement Instructions provide the relevant information regarding replications.

The Commissions' staff also requested certain information regarding any state regulatory limits on the use of derivatives. NAIC staff explained that the extent and nature of the use of derivatives by insurers is governed by the state investment laws referenced above, which vary to some degree by state. While these investment laws dictate the extent and nature of most insurers' investments including derivatives, several states also permit insurers some flexibility to invest in instruments not specifically prohibited, including derivatives up to certain specified aggregate limits. States provide insurers this flexibility in recognition of the unique characteristics insurance companies may possess and the different investment strategies their business needs may require. Commissions' staff requested information as to the extent of such limits, which are generally delineated in these investment laws as a percentage of "admitted

³ These instructions and disclosures are used for life insurers and are provided as examples. However, the information regarding replications called for by these disclosures and the handling of RBC charges for replications/synthetic assets is the same for all insurers filing the RBC calculation.

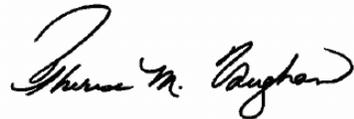
assets,”⁴ and are generally within the range of 5 percent or 10 percent of admitted assets, though they can be as high as 20 percent.⁵

In conclusion, we appreciate the open and constructive dialogue we have had to date with the Commissions’ staff. Should you wish to discuss these responses or any other matter relating to the NAIC’s views on the rulemaking process, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980, Moira Campion McConaghy, Government Relations Manager, at (202) 649-4997, or Mark Sagat, Government Relations Analyst and Counsel, at (202) 471-3987.

Sincerely,



Jane L. Cline, Commissioner
West Virginia Insurance Department
NAIC President



Therese M. Vaughan, Ph.D.
NAIC Chief Executive Officer

⁴ Admitted Assets are those assets which an insurer can count towards statutory surplus. Those admitted assets are used in the risk based capital formula, which is a tool state insurance regulators use to take specified action on insurers with capital and surplus below regulatory levels.

⁵ See, e.g., CAL. INS. CODE. § 1210 (2010)(5%); FLA. STAT. ANN. § 625.331 (2010) (5%); GA. CODE. ANN. § 33-11-55 (2010)(10%); MINN. STAT. ANN. §§ 60L.07, 61A.28 (2010)(5%); N.Y. INS. LAW §§ 1404, 1405 (2010)(5%-14%); OHIO REV. CODE ANN. § 3925.08(2010)(6%); PA. STAT. 40 P.S. §§ 504.2, 653c (2010)(20%); Tex. INS. CODE ANN. §§ 424.052, 425.152 (2009)(5%).