STATE OF NEW YORK
INSURANCE DEPARTMENT
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NEW YORK, NEW YORK 10004

David A. Paterson
Governor

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Superintendent

Circular Letter No. 16 (2010)

October 15 , 2010

TO: All Authorized Insurers

RE: Prudent Practices for Insurers Engaged in Securities Lending

STATUTORY REFERENCE: New York Insurance Law §§ 201, 301, 1401-1414

I. PURPOSE

The purpose of this Circular Letter is to advise the industry regarding the Department's expectations for insurers that engage in securities lending.

II. BACKGROUND

Securities lending is a practice whereby an insurer loans securities, either directly or through a custodial bank, to a borrower in exchange for collateral, each to be returned at a specified future date or on demand by either party.

In Circular Letter No. 16 (2008) ("CL 16"), the Department expressed concern about the practice of securities lending by insurers. At that time, the Department had become aware that some insurers had experienced significant losses due to their securities lending programs. Three of the Department's major areas of concern were whether insurers were: 1) receiving adequate collateral in exchange for loaned securities; 2) effectively managing the risk associated with investing cash collateral; and 3) clearly reporting their securities lending activities. The economic environment since CL 16 was issued has exacerbated the risk to insurers when they both loan securities and invest cash received as collateral for the loaned security.

III. PRUDENT PRACTICES

As a follow up to the issuance of CL 16 and in light of the subsequent financial crisis, the Department closely examined insurers' securities lending activities. This Circular Letter sets forth prudent practices that the Department believes an insurer should follow in conducting a securities lending program. The Department modeled the recommendations of this Circular Letter on pre-existing industry practices that it considers prudent in light of recent economic events. In sum, an insurer should effectively manage credit, market, and operational risk associated with lending securities. An insurer whose securities lending practices materially deviate from those outlined herein should communicate with the Department regarding the nature of the deviations.

A. Size of Securities Lending Program as Percentage of Admitted Assets

So that losses resulting from the lending of a security, or the investment of cash collateral, do not threaten the financial strength of an insurer, the insurer should effectively mitigate credit, market, and operational risk by limiting the size of its securities lending program. If an insurer's loan of a particular security, together with its outstanding loans of all other securities, will exceed, when the loan is made, five percent of the insurer's admitted assets as shown by its last sworn statement to the Superintendent, then the insurer making such a loan may not be acting prudently.

B. Borrower Concentration and Creditworthiness

Excessive securities lending to any single borrower can magnify credit risk. While the Department recognizes that borrower availability may fluctuate, an insurer should include securities loans made to any single borrower, together with the borrower's subsidiaries and affiliates, against the limitation set forth in New York Insurance Law § 1409(a).

In addition, an insurer engaged in lending securities should establish a management or supervisory committee, overseen by its board of directors or other governing body, to establish guidelines setting forth criteria for evaluating the creditworthiness of a securities borrower ("Securities Lending Risk Management Committee" or "SLRMC").[1]

C. Amount of Collateral and Systematic "True-up"

The Department has found that many insurers do not consistently comply with Statement of Statutory Accounting Principles ("SSAP") No. 91R ¶ 57 (National Association of Insurance Commissioners 2009), which the Department has adopted as part of its regulations. See New York Comp. Codes R. & Reg., tit. 11 ("11 NYCRR"), Part 83 (Regulation 172). SSAP 91R ¶ 57 requires insurers to hold cash collateral equal to 102 percent of the fair value of a loaned security for a domestic security, and 105 percent of the fair value of a loaned security for a foreign security. If the fair value of the collateral does not meet the aforementioned standards, the

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[1] An insurer could prudently choose to make its SLRMC a sub-division of a pre-existing body, such as an audit committee.

insurer must require the borrower to deliver additional collateral so that the aggregate collateral levels meet the requirements set forth in SSAP 91R ¶ 57.

D. Investment of Cash Collateral

Typically, an insurer that receives cash collateral in exchange for a loaned security repays the borrower at a future date upon the return of the security. If an insurer chooses to invest the cash collateral in the meantime, then the insurer should mitigate against market risk by having its SLRMC establish guidelines for the investment of the cash collateral.

Such guidelines should set forth prudent investment practices designed to reduce the likelihood of an insurer incurring losses when returning cash collateral. Based on industry best practices, the Department considers it prudent for an insurer to limit its investments to the following:

1. obligations issued, assumed, guaranteed or insured by the United States or by any agency or instrumentality thereof, by any state of the United States and by any territory or possession of the United States or any other governmental entity in the United States;

2. corporate debt securities;

3. loan-backed and structured securities;

4. commercial paper; and

5. money market funds.

An insurer may also use cash collateral to enter into reverse repurchase agreements, subject to the concentration limitations suggested below.

Insurers can also mitigate market risk by diversifying the investment of cash collateral. Insurers should be careful not to concentrate their investment of cash collateral in any one type of security. Thus, the Department suggests that insurers not:

1. invest more than 40% of cash collateral in corporate debt securities, loan-backed or structured securities; or

2. enter into a reverse repurchase agreement in which the insurer agrees to pledge more than 25% of its available cash collateral to a single counterparty.

Additionally, when investing cash collateral, an insurer should consider the National Association of Insurance Commissioners (“NAIC”) designations associated with securities, and invest cash collateral in:

1. securities designated as NAIC 1;

2. commercial paper rated A1/P1; or

3. the following asset classes as classified by the Securities Valuation Office of the NAIC:

   (i) Class 1 mutual fund investments;

   (ii) Direct or full faith obligations of the United States; and

   (iii) Bond mutual funds.

An insurer should aggregate its investment of cash collateral with all of its other investment activities. In other words, an insurer should consider investments of cash collateral in determining the timing and amount of projected cash flows for any financial analyses.

E. Maturity

An insurer should take care that the maturity date[2] of an investment made with cash collateral closely matches the date that the cash collateral must be returned in exchange for the loaned securities. Any mismatch may adversely affect an insurer's balance sheet and negatively impact its surplus. In order to mitigate the risk associated with a mismatch, an insurer should limit the mismatch to no more than one year in the aggregate.

F. Indemnification

It is possible that the liquidation proceeds of invested collateral could fail to cover the cost of acquiring a security equivalent to the loaned security when the loaned security is not returned by the security borrower. Therefore, in instances where an insurer appoints an agent, in the form of a custodial bank or other entity, to execute securities loans on its behalf, the insurer should require in the securities loan agreement that, in the event a borrower fails to return a loaned security and the liquidation proceeds of any investments and collateral are insufficient to purchase a security of the same issuer, issue, class and quantity as the loaned security, the agent will credit the insurer's account in an amount equal to the fair value of the unreturned loaned security minus the liquidation proceeds of any investments made with the cash collateral.

G. Written Agreements

All loans of securities should be memorialized in the form of a written agreement between the lender and the borrower. If the insurer has authorized an agent to execute securities

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[2] "Maturity date" is the earlier of the date on the face of the instrument on which the principal amount must be paid or for an instrument with an unconditional put or unconditional demand feature, the date on which the principal amount of the instrument can be recovered by demand. For asset-backed securities, the maturity date is the expected maturity date.

loans on its behalf, then the agreement with the borrower should be signed by the agent on behalf of the lender.

IV. REPORTING

Any insurer making securities loans should maintain records in accordance with 11 NYCRR § 243 (Regulation 152). Records should include:

1. all securities out on loan;
2. outstanding loans indexed to borrowers;
3. outstanding loans indexed to separate accounts;
4. the amount of collateral posted for each loan and each counterparty; and
5. a detailed schedule of reinvested collateral, including the carried book value and the fair value.

V. CONCLUSION

The Superintendent will continue to monitor insurers' securities lending practices and may promulgate regulations or seek legislation, as necessary, if the Superintendent concludes that insurers are not engaging in securities lending activities in a prudent manner and in accordance with the Insurance Law.

Any questions regarding this Circular Letter should be directed to Jared Wilner, Assistant Counsel to the Superintendent, at jwilner@ins.state.ny.us.

Sincerely,

Michael Moriarty
Deputy Superintendent