

guaranteed by the U.S. government to 30% of the value of common stock to 100% of the carrying value of foreign domiciled subsidiaries. The insurance risk category imposes capital levels with respect to an insurer's liabilities and obligations. In general, liabilities under health insurance policies require higher capital levels than liabilities under life insurance policies. The interest rate risk category is designed to cover the risk of losses from annuity and other deposit type liabilities with interest guarantees as a result of interest rate swings. Capital requirements range from .75% to 3% of reserve amounts. The business risk category is designed to account for the risk of state guaranty fund assessments and is a percentage of life and annuity premiums.

An insurance company's RBC level is calculated using the company's "total adjusted capital" (which is the sum of its statutory surplus, asset valuation reserve, voluntary investment reserves, and half of the annual dividend liability as adjusted for the capital contribution by subsidiaries) as the numerator and its RBC number as the denominator. If an insurance company's RBC level is equal to or greater than the "company action level," then no regulatory intervention is required under the Model Act. A ratio of 200 percent or more is necessary for a life or health insurance company to avoid any regulatory action.⁹

In December 1993, the NAIC adopted similar risk-based standards for property and casualty insurance companies. These standards will take effect for the 1994 annual financial reports. The RBC property and casualty insurance companies is based on asset risk, credit risk, loss reserve risk, and written premium risk. The asset risk capital represents the capital required to support the risk of potential default of invested assets. Credit risk capital represents the capital required to support the risk of default by reinsurers and other creditors. Loss reserve risk capital represents the capital required to support the risk of adverse development in excess of expected investment income from loss reserves. Written premium risk represents the capital required to support the risk of inadequate rates on business written over the coming year. As with life and health insurers, the RBC level for

⁹ If a life or health insurance company's RBC level is between 150–200%, under the Model Act regulators would require a company to file a plan to increase the capital ratio to greater than 200%. At a RBC level of 100–150%, regulators would do an examination of the company and issue corrective orders. At 70–100%, the regulators would be authorized to take control of the company. Below 70%, the regulators would be required to take control of a company.

property and casualty insurers is calculated by dividing the insurer's surplus by its calculated RBC. The "company action level" for property and casualty insurers is 80%.¹⁰

There are several private organizations that rate insurance companies. A.M. Best ("Best") was the first rating agency to report on the condition of insurance companies. Standards & Poor's ("S&P"), Moody's, and Duff & Phelps ("D&P") also rate insurance companies.

(B) Membership Standards

As a result of the regulation of insurance companies by the states, no uniform regulatory financial standard exists for insurance companies. Instead, the proposed rule change relies on the analysis and rating of each insurance company provided by the rating agencies as a proxy for such a uniform standard. The proposal also establishes a "size" test that at least initially only insurance companies of substantial size can meet and requires that insurance company netting members have a satisfactory RBC level.

Specifically, the proposal establishes the following minimum financial standards for insurance company netting members to be accepted into GSCC Netting System membership:

(1) A Best's rating of "A –" or better (if the member is rated by Best),¹¹

(2) A rating by at least one of the other three major rating agencies (D&P, Moody's, or S&P) of at least "A –" or "A3", as applicable (or an equivalent rating by either a nationally-recognized statistical rating organization or another rating agency acceptable to GSCC),

(3) No rating by any one of the other three major rating agencies of less than "A –" or "A3", as applicable,¹²

(4) A RBC level equal to or greater than the applicable "company action level" as set forth in the Risk-Based Capital for Insurers Model Act, and

¹⁰ Under the Model Act, at an RBC level at 28% or less regulators would be required to take control of a company.

¹¹ Best's ratings are as follows:

A++ and A+=superior
A and A –=excellent
B++ and B+=very good
B and B –=good
C++ and C+=fair
C and C –=marginal
D=below minimum standards
E=under state supervision
F=in liquidation

Currently, approximately one-third of all life insurance companies rated by Best and over one-half of all property and casualty insurance companies rated by Best have a rating of A – or better.

¹² A rating of below "A –" or "A3" by one of the other three major rating agencies generally indicates some weakness.

(5) Statutory capital (consisting of adjusted policyholders' surplus plus the company's asset valuation reserve) of no less than \$500 million.¹³

(C) Reporting Requirements

Each applicant for membership in GSCC's Netting System that is an insurance company will be required to provide its two most recent annual statements and three most recent quarterly financial statements filed with the NAIC, the Commission, and/or the applicant's regulatory authority in its state of domicile. In order to monitor the financial status of insurance company netting members on an ongoing basis, each such member will be required to provide GSCC with copies of its quarterly and annual financial statements and any intervening amendments and addendums thereto at the time that such statements are filed with the NAIC, the Commission, and/or the member's regulatory authority in its state of domicile.

II. Discussion

Section 17A(b)(3)(B) of the Act¹⁴ provides that the rules of a clearing agency must provide that certain types of entities, including insurance companies, may become participants in such clearing agency. Section 17A(b)(4)(B) of the Act¹⁵ provides that a registered clearing agency may deny participation to or condition the participation of any person if such person does not meet such standards of financial responsibility, operational capacity, experience, and competence as are prescribed by the rules of the clearing agency.

In the Commission's release adopting standards for clearing agency registration ("Standards Release"), the Commission stated that although the categories enumerated by Section 17A(b)(3)(B) are already subject to regulation by various federal and state authorities, such regulation does not necessarily qualify an applicant for participation in a clearing agency.¹⁶ Instead, a clearing agency may impose such additional or higher standards as it deems necessary to protect the clearing agency and its participants from unreasonable risks.

In its registration application, GSCC requested an exemption from Sections 17A(b)(3)(B) and 17A(b)(4)(B) of the Act. At that time GSCC's rules did not

¹³ Currently, this standard encompasses roughly the twenty-five largest life insurers and the twenty-five largest property and casualty insurers.

¹⁴ 15 U.S.C. 78q-1(b)(3)(B) (1988).

¹⁵ 15 U.S.C. 78q-1(b)(4)(B) (1988).

¹⁶ Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920.