

40-2a24. Financial futures contracts; definitions; use for hedging purposes; definitions. (a) Any insurance company other than life organized under any law of this state may use financial instruments under this section to engage in hedging transactions and certain income generation transactions or as these terms may be further defined in regulations promulgated by the commissioner. The insurance company shall be able to demonstrate to the commissioner the intended hedging characteristics and the ongoing effectiveness of the financial instrument transaction or combination of the transactions through cash flow testing or other appropriate analysis.

(b) As used in this section:

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

(2) "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.

(3) (A) "Financial instrument" means an agreement, option, instrument or any series or combination thereof:

(i) 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

(ii) which 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.

(B) Financial instruments include options, warrants, caps, floors, collars, swaps, forwards, future and any other agreements, options or instruments substantially similar thereto, or any series or combination thereof.

(4) "Financial instrument transaction" means a transaction involving the use of one or more financial instruments.

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

(6) "Forward" means an agreement (other than a future) 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.

(7) "Future" means an agreement traded on a qualified 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.

(8) "Hedging transaction" means a financial instrument transaction which is entered into and maintained to reduce:

(A) The risk of a 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

(B) 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.

(9) "Income generation transaction" means a financial instrument transaction involving the writing of the covered call options which is intended to generate income or enhance return.

(10) "Option" means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, level, performance or value of one or more underlying interests.

(11) "Potential exposure" means:

(A) As to a futures position, the amount of the initial margin required for that position; or

(B) as to swaps' collars and forwards, .5% times the notional amount times the square root of the remaining years of maturity.

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

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

(14) "Warrants" means an option to purchase or sell the underlying securities or investments at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another corporation.

(c) An insurance company may enter into financial instrument transactions for the purpose of hedging except that the transaction shall not cause any of the following limits to be exceeded:

(1) The aggregate statement value of options, caps, floors and warrants not attached to any other security or investment purchase in hedging transactions may not exceed 110% of the excess of such insurer's capital and surplus as shown on the company's last annual or quarterly report filed with the commissioner of insurance over the minimum requirements of a new stock or mutual company to qualify for a certificate of authority to write the kind of insurance which the insurer is authorized to write;

(2) the aggregate statement value of options, caps and floors written in hedging transactions may not exceed 3% of the insurance company's admitted assets; and

(3) the aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions may not exceed 5% of the insurance company's admitted assets.

(d) An insurance company may enter into the following types of income generation transactions if:

(1) Selling covered call options on noncallable fixed income securities or financial instruments based on fixed income securities, but the aggregate statement value of assets subject to call during the complete term of the call options sold, plus the face value of fixed income securities underlying any financial instrument subject to call, may not exceed 10% of the insurance company's admitted assets; and

(2) selling covered call options on equity securities, if the insurance company holds in its portfolio the equity securities subject to call during the complete term of the call option sold.

(e) Upon request of the insurance company, the commissioner may approve additional transactions involving the use of financial instruments in excess of the limits of subsection (c) or for other risk management purposes, excluding replication transactions, pursuant to regulations promulgated by the commissioner.

(f) For the purposes of this section, the value or amount of an investment acquired or held under this section, unless otherwise specified in this code, shall be the value at which assets of an insurer are required to be reported for

statutory accounting purposes as determined in accordance with procedures prescribed in published accounting and valuation standards of the national association of insurance commissioners (NAIC), including the purposes and procedures of the securities valuation office, the valuation of securities manual, the accounting practices and procedures manual, the annual statement instructions or any successor valuation procedures officially adopted by the NAIC.

(g) Prior to engaging in transactions in financial instruments, an insurer shall develop and adequately document policies and procedures regarding investment strategies and objectives, recordkeeping needs and reporting matters. Such policies and procedures shall address authorized investments, investment limitations, authorization and approval procedures, accounting and reporting procedures and controls and shall provide for review of activity in financial instruments by the insurer's board of directors or such board's designee.

Recordkeeping systems must be sufficiently detailed to permit internal auditors and insurance department examiners to determine whether operating personnel have acted in accordance with established policies and procedures, as provided in this section. Insurer records must identify for each transaction the related financial instruments contracts.

History: L. 1985, ch. 156, § 2; L. 1996, ch. 83, § 1; July 1.