H-2459.1

SUBSTITUTE HOUSE BILL 2097

State of Washington 55th Legislature 1997 Regular Session

By House Committee on Financial Institutions & Insurance (originally sponsored by Representative L. Thomas)

Read first time 03/05/97.

AN ACT Relating to investment practices of insurance companies; and adding a new section to chapter 48.13 RCW.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

NEW SECTION. **Sec. 1.** A new section is added to chapter 48.13 RCW to read as follows:

(1) An insurer may, directly or indirectly through an investment subsidiary, engage in derivative transactions under this section under the following conditions:

(a) An insurer may use derivative instruments under this section to engage in hedging transactions and certain income generation transactions, as these terms may be further defined by rule by the insurance commissioner;

(b) An insurer shall annually demonstrate to the satisfaction of the insurance commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of transactions through cash flow testing or other appropriate analysis;

(c) An insurer may enter into hedging transactions under this section if, as a result of and after giving effect to the transaction:

(i) The aggregate statement value of options, caps, floors, and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one-half percent of its admitted assets;

(ii) The aggregate statement value of options, caps, and floors written in hedging transactions does not exceed three percent of its admitted assets; and

(iii) The aggregate potential exposure of collars, swaps, forwards, and futures used in hedging transactions does not exceed six and one-half percent of its admitted assets;

(d) An insurer may only enter into the following types of income generation transactions if, as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent of its admitted assets:

(i) Sales of covered call options on noncallable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the noncallable period, or derivative instruments based on fixed income securities;

(ii) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants, or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;

(iii) Sales of covered puts on investments that the insurer is permitted to acquire under this chapter, if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or

(iv) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding;

(e) An insurer shall include all counterparty exposure amounts in determining compliance with general diversification requirements and medium and low grade investment limitations under this chapter; and

(f) Pursuant to rules adopted by the insurance commissioner under subsection (3) of this section, the commissioner may approve additional transactions involving the use of derivative instruments in excess of the limitations in (c) of this subsection or for other risk management purposes under rules adopted by the commissioner, but replication transactions shall not be permitted for other than risk management purposes.

(2) For purposes of this section:

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

(b) "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;

(c) "Counterparty exposure amount" means the net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse. The amount of the credit risk equals the market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer, or zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

If over-the-counter derivative instruments are entered into under a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or, if not within the United States, within a foreign jurisdiction listed in the purposes and procedures of the securities valuation office as eligible for netting, the net amount of credit risk shall be the greater of zero or the sum of:

(i) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer; and

(ii) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

For open transactions, market value shall be determined at the end of the most recent quarter of the insurer's fiscal year and shall be reduced by the market value of acceptable collateral held by the insurer or placed in escrow by one or both parties;

(d) "Covered" means that an insurer owns or can immediately acquire, through the exercise of options, warrants or conversion rights already owned, the underlying interest in order to fulfill or secure its obligations under a call option, cap or floor it has written, or has set aside under a custodial or escrow agreement cash or cash equivalents with a market value equal to the amount required to fulfill its obligations under a put option it has written, in an income generation transaction;

(e) "Derivative instrument" means an agreement, option, instrument, or a 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) That 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.

Derivative instruments include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures, and any other agreements, options, or instruments substantially similar thereto or any series or combination thereof and any agreements, options, or instruments permitted under rules adopted by the commissioner under subsection (3) of this section;

(f) "Derivative transaction" means a transaction involving the use of one or more derivative instruments;

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

(h) "Future" means an agreement, traded on a qualified exchange or qualified foreign 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;

(i) "Hedging transaction" means a derivative transaction which is entered into and maintained to reduce:

(i) 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

(ii) 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;

(j) "Option" means an agreement giving the buyer the right to buy or receive (a "call option"), sell or deliver (a "put option"), 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;

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

(l) "Underlying interest" means the assets, liabilities, other interests, or a combination thereof underlying a derivative instrument, such as any one or more securities, currencies, rates, indices, commodities, or derivative instruments; and

(m) "Warrant" means an instrument that gives the holder the right to purchase an underlying financial instrument 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, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

(3) The insurance commissioner may adopt rules implementing the provisions of this section.

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