

CERTIFICATION OF ENROLLMENT
SUBSTITUTE HOUSE BILL 2097

55th Legislature
1997 Regular Session

Passed by the House March 15, 1997
Yeas 81 Nays 15

Speaker of the
House of Representatives

Passed by the Senate April 18, 1997
Yeas 45 Nays 0

President of the Senate

Approved

Governor of the State of Washington

CERTIFICATE

I, Timothy A. Martin, Chief Clerk of the House of Representatives of the State of Washington, do hereby certify that the attached is **SUBSTITUTE HOUSE BILL 2097** as passed by the House of Representatives and the Senate on the dates hereon set forth.

Chief Clerk

FILED

Secretary of State
State of Washington

SUBSTITUTE HOUSE BILL 2097

Passed Legislature - 1997 Regular Session
AS RECOMMENDED BY THE CONFERENCE COMMITTEE

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.

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

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

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

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

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

13 (b) Derivative instruments shall not be used for speculative
14 purposes, but only as stated in (a) of this subsection;

15 (c) An insurer shall be able to demonstrate to the insurance
16 commissioner the intended hedging characteristics and the ongoing
17 effectiveness of the derivative transaction or combination of
18 transactions through cash flow testing or other appropriate analysis;

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

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

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

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

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

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

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

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

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

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

4 (g) Pursuant to rules adopted by the insurance commissioner under
5 subsection (3) of this section, the commissioner may approve additional
6 transactions involving the use of derivative instruments in excess of
7 the limitations in (d) of this subsection or for other risk management
8 purposes under rules adopted by the commissioner, but replication
9 transactions shall not be permitted for other than risk management
10 purposes.

11 (2) For purposes of this section:

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

17 (b) "Collar" means an agreement to receive payments as the buyer of
18 an option, cap, or floor and to make payments as the seller of a
19 different option, cap, or floor;

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

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

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

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

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

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

17 (e) "Derivative instrument" means an agreement, option, instrument,
18 or a series or combination thereof:

19 (i) To make or take delivery of, or assume or relinquish, a
20 specified amount of one or more underlying interests, or to make a cash
21 settlement in lieu thereof; or

22 (ii) That has a price, performance, value, or cash flow based
23 primarily upon the actual or expected price, level, performance, value,
24 or cash flow of one or more underlying interests.

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

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

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

1 (h) "Future" means an agreement, traded on a qualified exchange or
2 qualified foreign exchange, to make or take delivery of, or effect a
3 cash settlement based on the actual or expected price, level,
4 performance, or value of, one or more underlying interests;

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

7 (i) The risk of a change in the value, yield, price, cash flow, or
8 quantity of assets or liabilities which the insurer has acquired or
9 incurred or anticipates acquiring or incurring; or

10 (ii) The currency exchange rate risk or the degree of exposure as
11 to assets or liabilities which an insurer has acquired or incurred or
12 anticipates acquiring or incurring;

13 (j) "Option" means an agreement giving the buyer the right to buy
14 or receive (a "call option"), sell or deliver (a "put option"), enter
15 into, extend, or terminate or effect a cash settlement based on the
16 actual or expected price, level, performance, or value of one or more
17 underlying interests;

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

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

25 (m) "Warrant" means an instrument that gives the holder the right
26 to purchase an underlying financial instrument at a given price and
27 time or at a series of prices and times outlined in the warrant
28 agreement. Warrants may be issued alone or in connection with the sale
29 of other securities, for example, as part of a merger or
30 recapitalization agreement, or to facilitate divestiture of the
31 securities of another business entity.

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

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