

THE INSURANCE CODE OF 1956 (EXCERPT)
Act 218 of 1956

500.943 Qualified assets; derivative instruments and transactions.

Sec. 943.

(1) Qualified assets for purposes of section 901 include derivative instruments only if the insurer is able to demonstrate to the commissioner through cash flow testing or other appropriate analyses both the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of transactions.

(2) Before engaging in a derivative transaction and with board of director approval, a domestic insurer shall do all of the following:

(a) Establish written guidelines to be used for effecting or maintaining derivative transactions. The guidelines shall be available to the commissioner on request and shall meet all of the following:

- (i) Address investment or, if applicable, underwriting objectives and risk constraints, such as credit risk limits.
- (ii) Address permissible derivative transactions and the relationship of those transactions to its operations.
- (iii) Require compliance with internal control procedures.

(b) Have a system for determining whether a derivative instrument used in a hedging or replication transaction is effective.

(c) Have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using counter party exposure amount.

(d) Determine whether the insurer has adequate professional personnel, technical expertise, and systems to implement investment practices involving derivatives.

(e) Determine that the derivative program is prudent and that the level of risk is appropriate for the insurer given the level of capitalization and expertise available to the insurer.

(3) Except as provided in section 222(7), written guidelines prepared pursuant to subsection (2), if furnished to the commissioner, are confidential and privileged, are not subject to the freedom of information act, 1976 PA 442, MCL 15.231 to 15.246, are not subject to subpoena, and are not subject to discovery or admissible in evidence in any private civil action.

(4) The commissioner may promulgate rules pursuant to the administrative procedures act of 1969, 1969 PA 306, MCL 24.201 to 24.328, to implement this section, including, but not limited to, the establishment of all of the following:

- (a) Financial solvency standards.
- (b) Valuation standards.
- (c) Reporting requirements.

(5) An insurer shall include all counter party exposure amounts in determining compliance with the limitations in section 901(6).

(6) In measuring the net amount of credit risk exposure using counter party exposure amount, all of the following apply:

(a) The net amount of 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.

(b) If over-the-counter derivative instruments are entered into pursuant to a written master agreement that provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counter party is either within the United States or, if not within the United States, within a foreign jurisdiction approved as eligible for netting, the net amount of credit risk is the greater of zero or the net sum of the market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment to the insurer and the market value of the over-the-counter derivative instruments entered into pursuant to the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

(7) As used in subsection (6), market value shall be determined for open transactions 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 1 or both parties.

(8) As used in 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 1 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) "Collateralized mortgage obligation" means an asset-backed security that has cash flows originating directly

or indirectly from underlying mortgage assets.

(d) "Counter party 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 or qualified foreign exchange or cleared through a qualified clearinghouse such as an over-the-counter derivative instrument.

(e) "Derivative instrument" means any agreement, option, or instrument, or any series or combinations of an agreement, option, or instrument to make or take delivery of, or assume or relinquish, a specified amount of 1 or more underlying interests, or to make a cash settlement in lieu of 1 or more underlying interests, or that has a price, performance, value, or cash flow based primarily upon the actual or expected price, yield, level, performance, value, or cash flow of 1 or more underlying interests. Derivative instruments include options, warrants, caps, floors, collars, swaps, swaptions, forwards, futures, and any other substantially similar agreements, options, or instruments, or any series or combinations and any further agreements, options, or instruments included under rules promulgated by the commissioner. Derivative instruments do not include collateralized mortgage obligations, other asset-backed securities, principal-protected structured securities, or instruments that an insurer is otherwise permitted to invest in or receive under this chapter other than under this section. The sale or purchase of a derivative instrument by an insurer in connection with a written investment policy that insulates the purchaser from the risk of default of an underlying financial instrument shall be treated as a derivative and not as insurance for purposes of this act.

(f) "Derivative transaction" means a transaction involving the use of 1 or more derivative instruments. For purposes of this section, dollar roll transactions, repurchase transactions, reverse repurchase transactions, and securities lending transactions are not derivative transactions.

(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 1 or more underlying interests.

(h) "Forward" means an agreement, other than a future, to make or take delivery in the future of 1 or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of the underlying interests. Forward includes spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

(i) "Future" means an agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of 1 or more underlying interests.

(j) "Hedging transaction" means a derivative transaction that is entered into and maintained to manage the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities that the insurer has acquired or incurred or anticipates acquiring or incurring or the currency exchange rate risk related to assets or liabilities that an insurer has acquired or incurred or anticipates acquiring or incurring.

(k) "Option" means an agreement giving the buyer the right to buy or receive, known as a call option, sell or deliver, known as a put option, enter into, extend, or terminate or effect a cash settlement based on the actual or expected price, spread, level, performance, or value of 1 or more underlying interests.

(l) "Replication transaction" means a derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer's investment portfolio in order to replicate the risks and returns of another authorized transaction, investment, or instrument or to operate as a substitute for cash market transactions. A derivative transaction entered into by the insurer as a hedging transaction is not a replication transaction.

(m) "Structured security" means an obligation whose principal or interest payments are determined partially or entirely by reference to an index, market, event, or asset unrelated to the issuer's ability to pay.

(n) "Swap" means an agreement to exchange or to net payments at 1 or more times based on the actual or expected price, yield, level, performance, or value of 1 or more underlying interests.

(o) "Swaption" means an option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

(p) "Underlying interest" means the assets, liabilities, other interests, or a combination of assets, liabilities, or other interests underlying a derivative instrument such as any 1 or more securities, currencies, rates, indices, commodities, or derivative instruments.

(q) "Warrant" means an instrument that gives the holder the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times outlined in the warrant agreement.

(9) The amendatory act that added this subsection does not affect the validity of any derivative transaction entered into or derivative instrument acquired by an insurer before the effective date of the amendatory act that added this subsection.

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