House
Legislative
Analysis
Section

House Office Building, 9 South
Lansing, Michigan 48909
Phone: 517/373-6466

INSURERS: REVISE QUALIFIED INVESTMENT PROVISIONS

House Bill 5927 (Substitute H-1)
First Analysis (5-7-02)

Sponsor: Rep. Andrew Richner
Committee: Insurance and Financial Services

THE APPARENT PROBLEM:

Under the Insurance Code, insurance companies are required to keep a minimum amount of capital and surplus, and also assets referred to as "qualified assets", sufficient to cover their liabilities. While companies are free to invest their "admitted assets" (the remaining total assets after subtracting capital and surplus and qualified assets from the total assets) as they see fit, the types and amounts of investments that are allowed to be counted as "qualified assets" are regulated by the code and overseen by the commissioner of the Office of Financial and Insurance Services (OFIS). Such regulation is important because risky investments or insufficient capital, surplus, and other assets to back a company's liabilities could put the company at risk for insolvency. Obviously, an insurance company that is insolvent will lack sufficient capital to pay out claims submitted by those who maintain insurance policies with that insurer.

One type of investment that has not been allowed to be counted as a qualified asset is the practice of investing in derivative products. The Financial Pipeline website, www.finpipe.com, explains some derivative products as an investment that has a payoff contingent upon the occurrence of some event for which a premium is paid by the investor in advance. Therefore, unlike the practice of investing in real estate by purchasing mortgages, or investing in precious metals by buying stores of gold or silver, investing in a derivative product does not entail purchasing the underlying instrument (such as the mortgage or precious metal). Rather, a derivative may involve buying a one month call option on a particular stock at a set price per share for a specified number of shares, which would be cheaper than buying the shares outright. If, at the end of the month, the stock price had increased, the option could be exercised and the stock purchased at the previous lower price and then sold again at the current higher price – resulting in a profit. If the stock price should fall during the month, the option to buy would not have to be exercised, and all that would be lost would be the price of the call option, which would be significantly less than if the shares had been bought outright. If managed well, derivatives have the ability to increase profits while minimizing risks; therefore, they have become an accepted and valuable investment strategy for insurance corporations.

Legislation has been proposed to allow insurance companies (with oversight and regulation by the OFIS) to count some of their investments in derivatives as qualified investments. It has also been proposed to codify the commissioner's interpretation of the provisions regulating qualified assets, as some have felt that the provisions in the code lack clarity.

THE CONTENT OF THE BILL:

The bill would make numerous changes to Chapter 9, entitled "Investments", of the Insurance Code, which regulates the investments of domestic insurers. The bill would also add numerous definitions for terms associated with investments.

Assets. The Insurance Code permits an insurer authorized to operate in Michigan to loan or invest its funds and transact other business related to its investments, property, and money to the same extent as any other person or corporation, provided that the insurer has qualified assets totaling at least the sum of its liabilities and reserves (plus an amount equal to the lesser of the minimum capital and surplus required to be maintained by the code or $1 million). The bill would make the following changes to Section 901 of the code regarding qualified assets:

- Currently, for the purpose of meeting the asset level required by the code, the value of all computers cannot exceed two percent of the assets required above and the value of each computer cannot exceed the original cost of the computer amortized over a

period not to exceed five years. The bill would decrease this time period to three years.

• A provision requiring that no more than 20 percent of the assets required by the code be high-yield, high-risk obligations, and a definition of "high-risk, high-yield obligations" would be moved from Section 922 of the code to Section 901. A domestic insurer's investment in governmental securities would be subject to these limitations.

• Instead of specifying that "an insurer may invest in . . ." or "an insurer may purchase . . .", provisions would be rewritten to say that "qualified assets for purposes of Section 901 include . . ."

• Currently, the assets required by Section 901 may include the value of amounts invested in or loaned to an affiliate authorized to transact insurance in any state or in Canada in an amount specified by the code. The bill would include - as qualified assets - loans (other than surplus notes) made to an affiliate authorized to transact insurance in any state or in Canada provided that the affiliate has assets in excess of the amount of assets that are required for the affiliate under Section 901. With the commissioner's approval, surplus notes could be treated as an investment for purposes of Section 901.

In addition, the bill would specify that except as otherwise provided in Sections 942, 943(2), and 946(4), Chapter 9 would not prohibit the investment of a domestic insurer's capital and surplus in any asset otherwise permitted to be held by any other person or corporation under the Michigan laws, provided the domestic insurer maintained qualified assets in the amounts specified above. As used in this provision, "qualified assets" would mean cash and those assets described in Sections 910 to 947.

Real Estate Investments. With certain limitations, the code permits insurers to invest in real estate loans that are secured by first liens upon improved or income-producing real estate or by first mortgages on leasehold estates. Although a loan generally must not be made for a term exceeding five years, exceptions are made for loans on certain residential property if the loan is secured by an amortized mortgage or similar instrument under which installment payments are sufficient to amortize the entire principal of the loan within 35 years.

The bill would include, as a qualified asset, a loan on multifamily residential property in an amount not to exceed 85 percent of the appraised value, at the time of the loan, of the real estate offered as security, if the loan was secured by a mortgage, deed of trust, or other instrument for a term of not more than 35 years. However, if the total amount of multifamily residential loans that exceed 75 percent of the appraised value of the real estate offered as security for those loans is greater than 20 percent of an insurer's mortgage portfolio, the portion of those loans that exceed 75 percent of the appraised value could not be treated as a qualified asset for purposes of Section 901 of the code.

In addition, a domestic insurer could not invest more than 10 percent of its surplus in real estate loans that exceeded the appraised value limitations in the code unless the real estate loan was the result of a restructuring of an existing real estate loan and the insurer provided written notice to the commissioner on or before the date of the restructuring. The commissioner could increase the 10 percent investment limit of this provision to 20 percent for an insurer who demonstrated to the commissioner's satisfaction the soundness of a particular investment or investment strategy that would cause the insurer to exceed the lower limit. If the loans under this provision exceeded five percent of an insurer's assets within any 12-month period, no other loans could be made except with the commissioner's prior approval. In addition, a domestic insurer could not invest more than 20 percent of its mortgage portfolio in multifamily residential mortgages that exceeded 75 percent of the appraised value, at the time of the loan, of the real estate offered as security.

Further, the code requires a loan secured by real estate to be in the form of obligations secured by mortgage, trust deed, or other such instrument. Currently, an insurer is allowed to purchase an obligation when the entire amount of the obligation is sold to the insurer. However, the insurer may also buy a part of an obligation if the other participants are insurers, banks, or savings and loan associations. The bill would include other financial institutions as allowable participants as long as an entity met the definition of financial institution contained in the Gramm-Leach-Bliley Act (12 U.S.C. 1811).

Derivative transactions. In a broad sense, derivatives are any investment whose rate of return is based on the movement in value of an underlying asset; futures contracts and stock options are forms of derivatives. Investment in derivatives allows investors to speculate on the movement of a particular market; therefore, derivatives represent one of the more volatile forms of investment. The value of a derivative investment is "derived" from the underlying assets, such as currencies, equities, or

commodities; an index, like the stock market; or an indicator, such as interest rates. A correct prediction on which way the market will move increases the value of the investment; if the investor were wrong, the value of the investment would decrease.

The bill would delete the provisions currently contained in Section 943 regarding financial futures contracts and put and call options and replace them with provisions pertaining to derivative transactions. The bill would specify that it would not affect the validity of any derivative transaction entered into or derivative instrument acquired by an insurer before the bill's effective date. Under the bill, "derivative transaction" would mean a transaction involving the use of one or more derivative instruments. For the purposes of Section 943, dollar roll transactions, repurchase transactions, reverse repurchase transactions, and securities lending transactions would not be derivative transactions.

A "derivative instrument" would mean any agreement, option, or instrument (or series or combinations thereof) 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 of one 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 one or more underlying interests. Derivative instruments would include options, warrants, caps, floors, collars, swaps, swaptions, forwards, futures, and other substantially similar agreements, options, or instruments. Not included would be collateralized mortgage obligations, other asset-backed securities, principal-protected structured securities, or instruments that an insurer was otherwise permitted to invest in or receive under Chapter 9 in provisions other than those in Section 943. For the purposes of the code, the bill would specify that the sale or purchase of a derivative instrument by an insurer in connection with a written investment policy that insulated the purchaser from the risk of default of an underlying financial instrument would have to be treated as a derivative and not as insurance.

Derivative instruments would be deemed qualified assets only if the insurer were 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. Before a domestic insurer could engage in a derivative transaction, the insurer would have to do the following:

- Establish written guidelines for effecting or maintaining derivative transactions. The guidelines would have to be available to the commissioner on request and would have to address certain criteria as specified in the bill.

- Have a system for determining whether a derivative instrument used in a hedging or replication transaction was effective. "Hedging transaction" would refer to a derivative transaction that was 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 had acquired or incurred or the currency exchange rate risk related to assets or liabilities that an insurer had acquired or incurred (or anticipated doing so). A "replication transaction" would mean a derivative transaction or combination of such 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. However, a derivative transaction entered into by the insurer as a hedging transaction would not be a replication transaction.

- Have a credit risk management system for over-the-counter derivative transactions that measure credit risk exposure using counter party exposure amount.

- Determine whether the insurer had adequate professional personnel, technical expertise, and systems to implement investment practices involving derivatives.

- Determine that the derivative program was prudent and that the level of risk was appropriate for the insurer given the level of capitalization and expertise available to the insurer.

Except as provided in Section 222(7) of the code, written guidelines prepared under the above provision – if furnished to the commissioner – would be confidential and privileged, and would not be subject to the Freedom of Information Act, not subject to subpoena, and not subject to discovery or admissible in evidence in any private civil action.

An insurer would have to include all counter party exposure amounts in determining compliance with the limitations in Section 901(6), which specifies that no more than five percent of the assets required by Section 901 can be invested in, loaned to, receivable from, secured by, leased or rented to, or deposited with one person or one group of affiliated persons or

invested in one parcel of real estate. Under the bill, "counter party exposure amount" would mean 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. In measuring the net amount of credit risk exposure using counter party exposure amount, all of the following would apply:

• 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 would be zero if the liquidation of the instrument would not result in a final cash payment to the insurer.

• If over-the-counter derivative instruments were 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 U.S. or within a foreign jurisdiction approved as eligible for netting, the net amount of credit risk is 1) the greater of zero; or 2) the net sum of 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 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). As used in this provision, market value would be determined for open transactions at the end of the most recent quarter of the insurer's fiscal year and would be reduced by the market value of acceptable collateral held by the insurer or placed in escrow by one or both parties.

MCL 500.901 et. al.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, the bill would have no direct fiscal impact on the state or on local units of government. (5-1-02)

ARGUMENTS:

For:

Many provisions in the Insurance Code relating to investments by insurance companies generally speak in terms of what insurance companies may invest in. This has led to some confusions as to whether those particular investments may be counted towards meeting a company's required level of qualified assets. The bill would clarify these provisions and would also codify some of the interpretations of the law by the commissioner of the Office of Financial and Insurance Services (OFIS). For example, the bill would codify the commissioner's interpretation of the law that surplus notes could be counted as a qualified asset with the commissioner's approval. It should be noted that insurance commissioners do not operate in isolation. Therefore, an interpretation of an insurance law is generally based on industry standards and practices and on industry models developed by the National Association of Insurance Commissioners (NAIC).

For:

Investing in derivatives has become an accepted investment strategy for insurance companies, with some in the industry feeling that the potential for high profits while managing risk makes such investments a necessity for large corporations. The existing law, however, was adopted in the late 1980s when using derivatives to reduce financial risk was just beginning to be explored and before many of the derivatives available today were widely used in the industry. The result is that Michigan's domestic insurers are not authorized to invest either their qualified assets or admitted assets (their surplus assets) in financial derivative products. This puts Michigan insurers at a competitive disadvantage with companies based in other states and countries. In particular, they do not enjoy the investment flexibility needed in today's market to stay strong for consumers and shareholders.

The bill would incorporate many of the provisions regarding derivatives contained in the National Association of Insurance Commissioner's (NAIC) Investments of Insurers Model Act – Defined Limits Version, which is currently used by at least 20 states. However, the bill also allows for oversight on the use of derivatives as a qualified investment by the commissioner. In short, the bill should allow greater investment flexibility and competitiveness for the state's domestic insurers while providing sufficient controls and oversight to enable companies to remain solvent.

Against:

Currently, insurance companies may not invest in certain real estate loans that exceed specified appraised value limitations. However, a committee amendment would allow insurers to invest up to 10 percent of their surplus assets in this type of real estate loan without input or oversight by the

commissioner. This could be problematic. When a small down payment is placed on the purchase of a property, the mortgage then represents the vast majority of the property's value; therefore, the insurance company buying such a mortgage assumes a higher risk than if the mortgage represented 50 percent or less of the property's value. Since bad real estate investments have taken down more than one business, the commissioner should retain the ability to review potential real estate investments in properties with a mortgage in excess of current allowable levels. Such oversight would protect consumers from being hurt by a company becoming insolvent due to such risky investments.

POSITIONS:

The Manufacturers Life Insurance Company supports the bill. (5-6-02)

The Michigan Insurance Coalition supports the bill. (5-6-02)

The American Insurance Association supports the bill. (5-6-02)

The Office of Financial and Insurance Services supports the bill, but has some concerns about the committee amendments that would allow a company to invest a portion of its surplus in real estate investments without the commissioner's prior approval. (5-6-02)

The Michigan Insurance Federation supports the bill, but would prefer that the limitation on mortgages and real estate found in Sections 942 and 946(6) be removed. (5-6-02)

Analyst: S. Stutzky

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.