STATE OF CONNECTICUT

INSURANCE DEPARTMENT

January 11, 2000
Bulletin Number FS-14c-00

TO: ALL DOMESTIC LIFE, ACCIDENT AND HEALTH AND PROPERTY-CASUALTY INSURANCE COMPANIES

SUBJECT: USE OF DERIVATIVES INSTRUMENTS

This Bulletin supersedes Insurance Department Bulletins FS-14a dated October 2, 1987 and FS-14b dated October 2, 1987 as further amended on December 26, 1990, and is effective immediately. Domestic insurance companies shall implement this guidance commencing with the filing of the 1999 annual statement.

This Department has determined that its prior Bulletins FS-14a and FS-14b no longer adequately address the derivative instruments available to domestic life, accident and health and property-casualty insurance companies (insurers). In the past five years, these instruments have become an integral part of risk reduction and management for insurers and there have been significant developments in regulatory, accounting and reporting requirements for derivative instruments. Based on these developments, the following guidance with respect to the regulatory oversight of derivatives, is promulgated:

1. Instruments Authorized

(a) Insurers may utilize *options, caps, floors, swaps, forwards, futures and collars* or similar instruments or combinations thereof.

(b) The terms utilized in (a) above shall have the following meanings:

(i) *Swaps* are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves.

(ii) *Options* are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument.

(iii) *Forwards* are contracts (other than futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument.

(iv) *Futures* are standardized forward contracts traded on a United States or Qualified Foreign Exchange. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S.Treasury bonds and bills), composite stock indices, and foreign currencies. For purposes of this Bulletin *Qualified Foreign Exchange* means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions:

(A) That has received regulatory comparability relief under Commodity Futures Trading Commission (CFTC) Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC's Regulations, 17 C.F.R. Part 30);

(B) That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief under CFTC rules 30.10 (as set forth in Appendix C to part 30 of the CFTC's Regulations, 17 C.F.R. Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or

(C) Upon which foreign stock index futures contracts are listed that are the subject of no-action relief issued by the CFTC's Office of General Counsel, provided that an exchange, board of trade or contact market that qualifies as a qualified foreign exchange only under this subsection, shall only be a qualified foreign exchange as to foreign stock index futures contracts that are the subject of no-action relief.

(v) *Caps* are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder's (purchaser) risk associated with an increase in a reference rate or index. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option.

(vi) *Floors* are option contracts in which the floor writer (seller), in return for a premium, agrees to limit or floor the floor holder's (purchaser) risk associated with a decline in a reference rate or index. Because a floor is an option-based contract, the floor holder has the right but not the obligation to exercise the option.

(vii) A *collar* is a combination of a cap and a floor (one purchased and one written).

2. **Permitted Usage**

(a) Insurers may utilize derivative instruments authorized in Section 1 above for the following purposes:

(i) *Hedging*
(ii) *Income Generation* or
(iii) *Replication (Synthetic Asset) Transaction*

(b) Terms used in (a) above shall have the following meanings:

(i) *Hedging* is a transaction involving the use of one or more derivative instruments which meets all requirements of one or more of the definitions of hedging adopted by the CFTC or one which is entered into and maintained to manage or reduce:

(A) The risk of 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.

(ii) *Income generation* is a derivative transaction involving the writing of covered call options, covered caps or covered floors that is intended to generate income or enhance return. The term *covered* means that an insurer owns or can immediately acquire, through the exercise of options, warrants or conversion rights already owned, the underlying interest or its economic equivalent in order to fulfill or secure its obligations under a call option, cap or floor it has written in an *income generation* transaction. For purposes of this Bulletin, *economic equivalent* means an asset or combination of assets with substantially similar investment-risk attributes as such underlying interest; provided, however, if an insurer uses cash as part of a combination of assets to create any such economic equivalent, the amount of cash must be an incidental part of that economic equivalent. For purposes of this subparagraph, *interest* means a right, claim or legal share in something, and does not refer to a charge for an extension of credit.

(iii) *Replication* (synthetic asset) transaction is a transaction involving the use of one or more derivative instruments of the types permitted under this Bulletin, entered into in conjunction with other permissible investments in order to reproduce the investment characteristics of otherwise permissible investments. A transaction involving the use of one or more derivative instruments entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

(c) A collar may be utilized for hedging purposes, for income generation purposes where the portion written by the insurer is covered and for replication purposes as permitted by this Bulletin.

3. Limitations on Hedging Transactions

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

(a) 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 (7.5%) of its admitted assets;

(b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and

(c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets. Potential exposure is a derived measure of the potential increase in derivative instrument credit risk exposure and is determined in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and Annual Statement Instructions Manuals.

Transactions entered into to hedge the currency risk of investments denominated in a currency other than United States dollars shall not be included in the above limits.

An insurer may purchase or sell one or more derivative instruments to offset any derivative instrument previously purchased or sold without regard to the above limits.

4. Limitations on Income Generation Transactions

An insurer may 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, does not exceed ten percent (10%) of its admitted assets:

(a) Sales of covered options on non-callable 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;

(b) 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;

(c) 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 throughout the entire period in which the cap or floor is outstanding.

5. Limitations on Replication (Synthetic Asset) Transactions

Any asset being replicated is subject to all of the provisions and limitations on the making thereof specified in Connecticut General Statutes §38a-102 through §38a-102i with respect to investments by the insurer as if the replication (synthetic asset) transaction constituted a direct investment by the insurer in the replicated asset.

6. Counterparty Exposure

An insurer may enter into a transaction for an Over-the-Counter Derivative Instrument only with a Qualified Counterparty. Counterparty exposure is the exposure to credit risk associated with the use of Over-the-Counter Derivative Instruments with a Counterparty, determined in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and Annual Statement Instructions Manuals and shall be included in determining compliance with any single or aggregate quantitative limitation on investments made by an insurer under Connecticut General Statute §38a-102 to §38a-102i.

Over-the-Counter Derivative Instrument means a derivative instrument which is authorized under this Bulletin and which is entered into with a party other than through a United States or Qualified Foreign Exchange, or cleared through a United States or Qualified Foreign Exchange which provides clearing services, including acting as a counterparty to each of the parties to a transaction such that the parties no longer have credit risk as to each other.

Qualified Counterparty means a party:
(1) that has a Credit Rating of A or better (or the equivalent by
at least one nationally recognized statistical rating organization;

(2) whose parent has a credit Rating of A or better (or the equivalent) by at least one nationally recognized statistical rating organization; or

(3) has Credit Enhancement for all of its financial or settlement obligations under the Over-the-Counter Derivative Instrument for the duration of the transaction from an entity that has a Credit Rating of A or better (or the equivalent) by at least one nationally recognized statistical rating organization for the benefit of the Insurer.

Credit Rating means a financial strength rating, issuer rating, senior long-term debt rating or other similar rating which assesses the creditworthiness of a party to meet its financial obligations.

Credit Enhancement includes, but is not limited to, a guarantee and/or credit insurance.

7. Guidelines

Each insurer utilizing derivatives shall establish written guidelines stating the policy objectives of management, permissible strategies, the relationship of those strategies to the insurer's operations and how such strategies reduce or control the insurer's market risk and otherwise save transaction costs or substitute for investments or liabilities. The insurer's guidelines shall contain a requirement that its board of directors or committee thereof charged with the responsibility of overseeing investments, establish a procedure to determine, at least annually, that all derivative transactions were made in accordance with policy objectives, permissible strategies, and the insurer's overall investment goals as outlined in its written guidelines.

A copy of such guidelines shall be filed for informational purposes with this Department no later than March 1, 2000. Any subsequent revisions to an insurer's written guidelines shall be filed with the Department, as they become effective. The Department shall treat these guidelines as confidential in accordance with Connecticut General Statute §38a-69a.

8. Accounting and Reporting

Transactions permitted by this Bulletin shall be accounted for and reported in accordance with the National Association of Insurance Commissioners Accounting Practices and Procedures Manual and Annual Statement Instructions Manuals.

9. Waiver

This Department, may in its discretion, from time to time waive one or more of the requirements contained in this Bulletin upon the written request of an insurer and a reasonable showing of the need for such waiver.

If you have any questions regarding this Bulletin, you may contact Frances J. O'Connor, Director of the Examination Division at (860) 297-3814.

George M. Reider, Jr.
Insurance Commissioner