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INSURERS: INVEST IN FUTURES

House Bill 4043 with committee amendment
First Analysis (3-12-87) Floor Copy

Sponsor: Rep. Paul Wartner
Committee: Insurance

THE APPARENT PROBLEM:

Some insurance companies want chapter 9 of the Insurance Code, which regulates investment practices, amended to permit them to invest in financial futures and options as a means of "hedging," or reducing the risks associated with their investment portfolios. A financial future is an agreement to buy or sell a specific amount of financial instruments for a given price on a given date or during a limited period of time. Options are contracts conveying the right to buy or sell a specific instrument at a fixed price (and, unlike futures contracts, need not be exercised). While futures trading is commonly a speculative venture, it can also be used conservatively, as protection against a stock market decline or a decline in interest rates. For example, an investor who anticipates a decline in interest rates could today buy a contract for the delivery of treasury bills at some specified time in the future at today's rates, thus "locking in" interest rates. There are a wide variety of such transactions available using futures contracts and options. This kind of hedging has become particularly important to life insurance companies because they increasingly deal in long-term products carrying guaranteed rates of return, which are often tied to current interest rates. The companies thus need stability and predictability in their portfolios. However, the insurance code does not permit Michigan companies to engage in this prudent practice.

THE CONTENT OF THE BILL:

The bill would amend Chapter 9 of the Insurance Code to permit insurance companies to invest in financial futures contracts, put options, and call options, subject to certain conditions. The insurance commissioner would be authorized to promulgate rules to implement the bill, including rules establishing financial solvency standards, valuation standards, and reporting requirements.

Under the bill, companies could only be involved with financial futures contracts and with options on financial future contracts or stock and bond index contracts as part of hedging (risk reduction) transactions. A company could not write a call option on a security it did not own or in an amount greater than securities it owned, and could only write a put option if its obligations were fully secured by a deposit of cash or cash equivalents. The bill would limit the maintenance margin outstanding from futures positions to ten percent of the company's excess over capital and surplus requirements, and a similar ten percent limitation would apply to put options and call options. ("Margin" refers to the deposit the company would have to maintain with a broker or other safekeeping agent.) Companies could only invest in instruments issued under terms and conditions set by a federally-regulated exchange.

(The bill defines a "financial futures contract" as "an exchange-traded agreement to make or take delivery of, or to make a cash settlement instead of delivery of, a specified amount of financial instruments on a specified date or period of time, under terms and conditions regulated by the Commodity Futures Trading Commission." A call is an option contract that gives the buyer a right to purchase a share of stock for a stated price within a given period of time. A put is an option that grants a buyer the right to sell stock for a stated price to the writer of the put. "Writing" a call or put is granting the purchaser of the contract the right to buy or sell. Calls and puts can also apply to stock index or bond index contracts, where no specific stock is involved.)

The bill would require each domestic insurance company to write guidelines covering its objectives in employing financial futures contracts, permissible financial future contract strategies, the relationship of those strategies to its operations, and how the strategies reduce the company's net investment rate exposure (MCL 500.943).

FISCAL IMPLICATIONS:

The bill has no fiscal implications, according to the Department of Licensing and Regulation (2-16-87).

ARGUMENTS:

For:

Investors commonly use futures contracts and options in conservative investment management, as hedges against stock market downturns and interest rate declines. It is prudent to do so, yet the insurance code does not permit Michigan insurance companies to use this valuable investment tool. The bill would allow the use of futures contracts and options only as hedges, as risk reduction strategies. It contains several safeguards, such as limiting the amount companies could put into such strategies, and prohibiting them from promising to sell securities they did not own. Life insurance companies will particularly benefit from this added flexibility because they deal in so many interest rate-sensitive products in a volatile interest rate economy.

Against:

The Insurance Bureau has pointed out that "even though options which are unfavorable to the insurer need not be exercised, these options are not without cost. It is possible that an insurer could spend a significant amount of money on options without showing any benefit as a result."

POSITIONS:

The Insurance Bureau, within the Department of Licensing and Regulation, supports the bill (2-16-87).

The Life Association of Michigan supports the bill (3-10-87).

Maccabees Mutual Life Insurance Company supports the bill (3-10-87).