SFA BILL ANALYSIS

Senate Fiscal Agency • Lansing, Michigan 48909 • (517) 373-5383

House Bill 4043 (as reported without amendment)
Sponsor: Representative Paul Wartner
House Committee: Insurance
Senate Committee: Commerce and Technology

Date Completed: 4-1-87

RATIONALE

Some insurance companies believe that Chapter 9 of the Insurance Code, which regulates investment practices, should be amended to permit investment in financial futures and options as a means of "hedging", or reducing the risks associated with investment. (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 commonly is a speculative venture, it can also be used prudently, 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 buy a contract today for the delivery of treasury bills at some specified future date at today's rates, thus "locking in" interest rates. A wide variety of such transactions are available using futures contracts and options. This kind of hedging has become particularly important to life insurance companies because increasingly they offer long-term investment opportunities carrying guaranteed rates of return, which are often tied to current interest rates. The companies contend that such practices will promote stability and predictability in their portfolios. The Insurance Code does not permit Michigan companies to engage in this practice, however.

CONTENT

House Bill 4043 would amend 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 to establish financial solvency standards, valuation standards, and reporting requirements.

Under the bill, companies could be involved with financial futures contracts and with options on financial future contracts or stock and bond index contracts only as part of hedging (risk reduction) transactions. A company could not write a call option on a security that it did not own or in an amount greater than securities it owned, and could write a put option only if its obligations were secured fully by a deposit of cash or cash equivalents. The bill would limit the maintenance margin outstanding from futures positions to 10% of the company's excess over capital and surplus requirements, and a similar 10% 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 invest only in instruments issued under terms and conditions set by a federally-regulated exchange.

The bill would define 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 means granting the purchaser of the contract the right to buy or sell. Calls and puts also can 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 IMPACT

The bill could result in a minor expenditure increase for the State by allowing the Insurance Commissioner to promulgate rules to govern financial solvency standards, valuation standards, and reporting requirements. The bill would have no fiscal impact on local governments.

ARGUMENTS

Supporting Argument

Investors commonly use futures contracts and options in investment management, as hedges against stock market downturns and interest rate declines. Many consider it prudent to do so, yet the Insurance Code does not permit Michigan insurance companies to use this type of 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, particularly, would benefit from this added flexibility because they deal in many interest rate-sensitive products.

Opposing Argument

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."

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