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## INSURANCE CODE - INS

**DIVISION 1. GENERAL RULES GOVERNING INSURANCE [100 - 1879.8]** ( *Division 1 enacted by Stats. 1935, Ch. 145.*  )

**PART 2. THE BUSINESS OF INSURANCE [680 - 1879.8]** ( *Part 2 enacted by Stats. 1935, Ch. 145.*  )

**CHAPTER 2. Incorporated Insurers [1140 - 1260]** ( *Chapter 2 enacted by Stats. 1935, Ch. 145.*  )

**ARTICLE 4.6. Hedging [1211 - 1212]** ( *Article 4.6 added by Stats. 1983, Ch. 1262, Sec. 1.*  )

**1211.** (a) For the purposes of this section the following definitions shall apply:

- (1) "Aggregate counterparty exposure" means the sum of the aggregate statement value options, swaptions, caps, floors, and warrants purchased, and the aggregate potential exposure of collars, swaps, forwards, and futures entered into.
- (2) "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 one or more underlying interests exceeds a predetermined number, sometimes referred to as the strike rate or strike price.
- (3) "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.
- (4) "Credit default swap" means an agreement obligating the buyer to pay a periodic payment to the seller in return for the seller's obligation to make a payment to the buyer if a credit event or events occur with respect to underlying interests or an entity, as specified in the documentation of the credit default swap.
- (5) "Derivative instrument" means an agreement, option, instrument, or a series or combination of those (A) 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 thereof, or (B) that has a price, performance, value, or cashflow based primarily upon the actual or expected price, level, performance, value, or cashflow of one or more underlying interests.

A derivative instrument includes all investment instruments or contracts that derive all or almost all of their value from the performance of an underlying market, index, or financial instruments. The term includes options, warrants, caps, floors, collars, swaps, credit default swaps, swaptions, forwards, and futures.

- (6) "Derivative transaction" means a transaction involving the use of one or more derivative instruments.
- (7) "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 one or more underlying interests.
- (8) "Forward" means an agreement, other than a future, to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of those underlying interests, but does not mean or include spot transactions effected within customary settlement periods, when issued purchases, or other similar cash market transactions.
- (9) "Future" means an agreement traded on an organized and qualified 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, one or more underlying interests.
- (10) "Hedging transaction" means a derivative transaction that is entered into and at all times maintained to reduce (A) risk due to a change in the value, yield, price, cashflow, or quantity of assets or liabilities that the insurer has acquired or incurred or

anticipates acquiring or incurring or (B) risk due to changes in the currency exchange rate or the degree of exposure as to assets or liabilities denominated in a foreign currency that an insurer has acquired or incurred or anticipates acquiring or incurring.

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

(A) For purposes of this paragraph, an agreement giving the buyer the right to buy or receive may also be called a "call option."

(B) For purposes of this paragraph, an agreement giving the buyer the right to sell or deliver may be called a "put option."

(12) "Potential exposure" means the amount determined in accordance with the National Association of Insurance Commissioners Annual Statement Instructions.

(13) "Qualified bank" means a bank or trust company that meets all of the following:

(A) The bank or trust company is organized and existing, or in the case of a branch or agency of a foreign banking organization is licensed, under federal law or the law of any state.

(B) The bank or trust company is regulated, supervised, and examined by the United States federal or state authorities having regulatory authority over banks and trust companies.

(C) The bank or trust company has assets in excess of five billion dollars (\$5,000,000,000).

(D) The bank or trust company has senior obligations outstanding, or has a parent corporation that has senior obligations outstanding, rated AA or better, or the equivalent, by two independent nationally recognized statistical rating organizations.

(E) The bank or trust company has a ratio of primary capital to total assets of at least 5<sup>1</sup>/<sub>2</sub> percent and a ratio of total capital to total assets of at least 6 percent.

(14) "Qualified counterparty" is a qualified broker or dealer or a qualified bank or other counterparty rated AA- or Aa3 or higher by a nationally recognized statistical rating organization.

(15) "Qualified broker or dealer" means a broker or dealer that is organized under the laws of a state and is registered under the Securities Exchange Act of 1934 (15 U.S.C. Sec. 78a et seq.), and has net capital in excess of two hundred fifty million dollars (\$250,000,000).

(16) "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 investment characteristic of another authorized transaction, investment, or instrument or that may operate as a substitute for cash market investments. A derivative transaction entered into by the insurer as a hedging transaction authorized pursuant to this section shall not be considered a replication transaction.

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

(18) "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.

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

(20) "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.

(b) Any domestic incorporated insurer having admitted assets, as of the preceding December 31, of at least one billion dollars (\$1,000,000,000) and capital and surplus of at least two hundred million dollars (\$200,000,000), after investing an amount equal to its required minimum paid-in capital in securities specified in Article 3 (commencing with Section 1170), may engage in derivative transactions pursuant to, and in compliance with, this section.

(c) An insurer may only use derivative instruments under this section to engage in hedging transactions and replication transactions authorized pursuant to this section.

(d) An insurer that engages in hedging transactions or replication transactions as authorized pursuant to this section shall do both of the following:

(1) Maintain its position in any outstanding derivative instrument used as part of a hedging transaction or replication transaction for only as long as the hedging transaction or replication transaction, as the case may be, continues to be effective in meeting the objective and the rationale the insurer identifies at the point of inception of the hedging or replication transaction.

(2) Be able to demonstrate to the commissioner, upon request, that any hedging transaction or replication transaction continues to be effective in meeting that objective and rationale.

(e) (1) The aggregate statement value, and potential exposure, of all transactions held under the authority of this section at any one time shall not be in excess of  $7\frac{1}{2}$  percent of the insurer's admitted assets, as of the preceding December 31.

(2) Hedging transactions under this section may only be made if, as a result of, and after giving effect to the transaction, all of the following is established:

(A) Excluding options acquired under Section 1212, the aggregate statement value of options, swaptions, caps, floors, and warrants purchased pursuant to this section does not exceed  $7\frac{1}{2}$  percent of its admitted assets as of the preceding December 31.

(B) Excluding options acquired under Section 1212, the aggregate statement value of options, swaptions, caps, and floors written pursuant to this section does not exceed 3 percent of its admitted assets as of the preceding December 31.

(C) Excluding futures entered into under Section 1212, the aggregate potential exposure of collars, swaps, forwards, and futures, entered into and, except for options acquired under Section 1212, options, swaptions, caps, and floors written pursuant to this section does not exceed  $6\frac{1}{2}$  percent of its admitted assets as of the preceding December 31.

(f) An insurer may purchase or sell one or more derivative instruments to offset any derivative instrument previously purchased or sold, as the case may be, without regard to the quantitative limitations of this section, provided that the derivative instrument is an exact offset to the original derivative instrument being offset.

(g) (1) The board of directors of any domestic insurer that makes investments pursuant to this section shall first adopt written guidelines for the making of the investments. The guidelines shall cover factors including concentration and diversification of counterparty risk, quality, maturity, and diversification of derivative investments, and other specifications, including investment strategies, asset liability management practices, the insurer's liquidity needs and its capital and surplus, and other factors that the board of directors deems appropriate. The guidelines shall also include processes and practices that will facilitate the monitoring of derivative transactions through cashflow testing or other methods to substantiate the effectiveness of the hedging strategies and derivative transactions and provide the board of directors of the committee thereof charged with the responsibility for supervising investments the opportunity to assure itself of the training, sufficient understanding, and competency of pertinent personnel implementing the derivative transactions.

(2) In order to address the need for appropriate oversight by senior management and by the board of directors, or a committee thereof charged with the responsibility for supervising investments, and to provide for a comprehensive risk management process, an insurer shall establish the following with respect to derivative transactions:

(A) Appropriate limits for various identified risks relevant to the derivative transactions used by the insurer.

(B) Procedures and practices that control the nature and amount of those risks.

(C) Adequate systems or processes for identifying and measuring those risks.

(D) Systems or processes for documenting, monitoring, and reporting risk exposures on a timely basis.

(E) Systems or processes of internal review and audit to ensure the integrity of the overall risk management process.

(3) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive and review quarterly reports which shall include all of the following:

(A) Information to ascertain that all derivative transactions have been made in accordance with delegations, standards, limitations, and investment objectives contained in the derivative guidelines.

(B) The outstanding derivative positions.

(C) The unrealized gains or losses thereon.

(D) The derivative transactions closed during the report period.

(E) A performance review of the derivative transactions.

(F) An evaluation of the risks and benefits of the derivative transactions.

(G) Other information necessary to ensure that the internal control procedures are being followed.

(4) The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall establish the following management oversight standards for derivative transactions:

(A) The board of directors, or a committee thereof charged with the responsibility for supervising investments, has an affirmative obligation to inform management of its desired risk tolerance levels. Management shall appropriately translate these risk tolerance levels into effective policies and procedures that address both individual transactions and entire portfolios.

(B) Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall receive sufficient information to assess the strengths and limitations of the insurer's risk measurement systems in order to determine appropriate risk limits. The board of directors, or a committee thereof charged with the responsibility for supervising investments, shall also review management's response to strengths and limitations identified through oversight processes such as stress testing, independent validation, and back-testing of risk measurement models. Management and the board of directors, or a committee thereof charged with the responsibility for supervising investments, shall consider the information identified by the oversight processes, including the potential for indirect effects of downside performance beyond the insurer's finances, when they determine and communicate their risk profile.

(C) When management or the board of directors, or a committee thereof charged with the responsibility for supervising investments, identifies weaknesses in the risk management process, they shall consider alternatives and take steps to strengthen that process and maintain detailed documentation of steps and actions taken.

(D) Actions shall be taken to correct any deficiencies in internal controls relative to derivative transactions, including any deficiencies determined by the independent certified public accountant in the evaluation of accounting procedures and internal controls and maintain detailed documentation of steps and actions taken.

(E) Personnel responsible for risk oversight functions shall possess independence, authority, and expertise.

(F) Issuer and counterparty credit decisions for each transaction shall be consistent with the overall credit standards of the insurer.

(G) In connection with each derivative transaction under this section, insurers shall maintain a statement in their records listing any member of the board of directors who is employed by, or a partner in, a party involved in the derivative transaction.

(5) The board of directors or committee charged with the responsibility of supervising investments shall determine at least quarterly whether all derivative transactions have been made in accordance with delegations, standards, limitations, and investment objectives prescribed in the guidelines. If the determinations are made by a committee of the board of directors, the minutes of the committee reflecting the determinations shall be recorded and a report thereon shall be submitted to the board for its review at the board's next meeting.

(6) The commissioner shall require the guidelines to be submitted and shall disapprove the guidelines if the insurer is unable to show that the guidelines are found sufficient to prevent financially unsound or hazardous transactions or practices.

(h) An insurer shall comply with applicable financial requirements as promulgated by the commissioner and the National Association of Insurance Commissioners included in the Purposes and Procedures Manual of the National Association of Insurance Commissioners Securities Valuation Office, the National Association of Insurance Commissioners Accounting Practices and Procedures Manual, and the National Association of Insurance Commissioners Annual Statement Instructions, including, but not limited to, the reporting of transfers, if any, of interests in the assets of the insurer pledged as collateral or interests in the assets of counterparties received as collateral in connection with derivative transactions.

(i) (1) The counterparty exposure under a derivative instrument entered into by an insurer authorized to engage in derivative transactions pursuant to this section shall be deemed to be an obligation of the institution to which the insurer is exposed to credit risk and shall be included in determining compliance with any single or aggregate quantitative limitation on investments made by an insurer under this section.

(2) An insurer shall only enter into derivative transactions with counterparties that are rated one by the Securities Valuation Office.

(3) Notwithstanding any single or aggregate quantitative limitation on investments made by an insurer under this section, the aggregate counterparty exposure under one or more derivative transactions to any single counterparty rated one by the Securities Valuation Office, other than a "qualified counterparty," shall be limited to one-half of 1 percent of an insurer's admitted assets, and all counterparties rated one by the Securities Valuation Office, other than qualified counterparties, shall be limited to 3 percent of an insurer's admitted assets.

(j) Investments made pursuant to this section, and related transactions, are deemed excess funds investments and shall be subject to the provisions of Sections 1153.5, 1154, and 1210, and Article 4 (commencing with Section 1190), provided that if an insurer classifies an investment under Section 1210 that investment shall continue to be subject to the limitations of paragraph (1) of subdivision (e). Notwithstanding anything to the contrary, a requirement providing that any derivative transaction be disposed of by the insurer pursuant to Section 1202 shall be deemed conclusive unless the insurer establishes that the derivative transaction or transactions are financially sound and not hazardous. This section shall only be deemed to permit replication of investments or instruments, that are otherwise permitted in this code, and that are reported in compliance with the requirements of the risk-based capital and risk-based capital instructions required by Section 739.2.

(k) Except as permitted in this section, nothing in this section shall be deemed to permit an investment, transaction, or practice that is not authorized by another section of this code. Exposure to risk by use of derivatives shall be consistent with the overall investment guidelines. Insurers shall not enter into derivative transactions in whole or in part with funds borrowed for that purpose, including, but not limited to, on margin.

(l) The commissioner may adopt rules and issue guidelines establishing standards and requirements relative to practices authorized in this section. In connection with any of the actions contemplated by this section to be taken by the commissioner, including review of an insurer's written guidelines with respect to derivative transactions and review of documentation maintained by an insurer with respect to derivative transactions, the commissioner may deem the actions to be an examination of an insurer subject to the provisions of Sections 730 to 738, inclusive. The commissioner shall issue regulations establishing requirements regarding the disclosure of affiliations and conflicts of interest between an insurer and persons contracted by the commissioner to perform services on behalf of the commissioner in connection with the matters authorized by this section.

(m) An insurer that is not engaged in the issuance of new policies of insurance and that is formed for the purpose of facilitating the rehabilitation of an insolvent insurer under Article 14 (commencing with Section 1010) of Chapter 1, shall, prior to engaging in any derivative transaction, obtain approval for each transaction from the commissioner, and shall otherwise comply with the requirements of this section. However, the insurer may, upon request to the commissioner, and upon showing satisfactory to the commissioner that prior approval of each transaction would not be in the best interests of the policyholders, request that the commissioner waive the requirement of prior approval and the insurer shall, in addition to complying with the requirements of this section, submit monthly written reports of all derivative transactions to the commissioner in the form required by the commissioner within 30 days of the prior month's end.

*(Amended by Stats. 2003, Ch. 62, Sec. 200. Effective January 1, 2004.)*

**1212.** (a) Any domestic incorporated insurer having aggregate capital and surplus as of the preceding December 31 of at least twenty-five million dollars (\$25,000,000), after investing an amount equal to its required minimum paid-in capital in securities specified in Article 3 (commencing with Section 1170), may purchase insurance futures contracts, purchase call options on insurance futures contracts, and sell put options on insurance futures contracts in bona fide hedging transactions, subject to the limitations set forth in this section.

Domestic insurers may sell insurance futures contracts, sell call options on insurance futures contracts, and purchase put options on insurance futures contracts only for the purpose of a closing transaction. No other sales of insurance futures contracts, sales of call options on insurance futures contracts, or purchases of put options on insurance futures contracts are authorized under this section.

(b) For purposes of this section, "insurance futures contracts" mean contracts based on indices of loss performance of insurance contracts and traded in accordance with the rules and procedures of a board of trade regulated by the Commodity Futures Trading Commission, or any successor agency, and subject to the terms and conditions of the Commodity Exchange Act (7 U.S.C. Sec. 1 et seq.), as amended. For purposes of this section, "put and call options on insurance futures contracts" mean put or call options, regulated in accordance with the rules of the board of trade on which the options are traded, on insurance futures contracts.

(c) No domestic insurer may purchase insurance futures contracts, purchase call options on insurance futures contracts, or sell put options on insurance futures contracts unless the insurance futures contracts are required to be settled in cash within nine months after the end of the loss period underlying the insurance futures contracts, and the relevant type of insurance futures contracts have attained an average daily trading volume of at least 250 contracts and an open interest of 1,000 contracts as reported by the relevant board of trade for the one-month period prior to the insurer initiating the transaction.

(d) A transaction will be considered a bona fide hedging transaction only if, upon execution, (1) the insurance futures contract or option is specifically identified with a group of insurance policies issued or reasonably expected to be issued by the insurer in the ordinary course of business and (2) the insurer's relevant underwriting or insurance-related risk exposures bear a correlation to the risk exposures of the index underlying the insurance futures contracts or options thereon entered into as part of the hedging transaction. For purposes of this section, "correlation" means that the loss experience of the policies hedged is, at the date of purchase of the insurance futures contracts, expected to develop similarly to the loss experience of the policies underlying the insurance futures contract when exposed to similar occurrences and conditions. The insurer shall identify this hedging transaction and the policies and written premiums hedged on its books and records and any insurance futures contract or option position shall be terminated as soon as possible after this correlation does not exist.

(e) Notwithstanding other limitations of this section, an insurer may hold open insurance futures contracts and put and call options on insurance futures contracts which do not exceed the equivalent of 75 percent of the insurer's written premium for each line of business, as designated in the annual statement required by Section 923, being hedged pursuant to this section. For purposes of this subdivision, equivalence shall be based on the par dollar value of the insurance futures contracts and an insurer's written premium shall be measured based on the loss period reflected in the underlying futures contracts.

(f) A domestic insurer shall not enter into hedging transactions in insurance futures contracts or options on insurance futures contracts unless the transaction is authorized or approved by the insurer's board of directors or a committee designated by the board. This authorization or approval shall be entered on the records or minutes of the domestic insurer and, if made upon the authority of a committee of directors, shall be submitted to the full board of directors for ratification at their next meeting. The entry of approval shall show the fact of entering into the hedging transaction, the specific policies hedged, the size of the hedge as measured pursuant to subdivision (e), and the name of each director voting to approve the hedging transaction.

(g) The commissioner may, in his or her discretion, by written order require the disposal of any insurance futures contracts or options on insurance futures contracts made in violation of this section. Pending a disposal pursuant to an order by the commissioner, the insurance futures contracts or options on insurance futures contracts shall not be given any effect on any statement required by this code purporting to show the financial condition of the domestic insurer or in measuring the financial condition of the domestic insurer for the purpose of determining whether the domestic insurer is solvent or insolvent. The commissioner may also, for good cause shown, order the disposal of any insurance futures contract or option on insurance futures contracts.

(h) Insurance futures contracts and put and call options on insurance futures contracts shall not be deemed to be investments for purposes of any investment limitations or authorizations contained in this code.

(i) The commissioner may adopt rules and guidelines establishing standards and requirements relative to practices authorized in this section. The commissioner shall issue a bulletin by June 30, 1994, setting forth the accounting, reporting, and valuation practices and procedures for insurance futures contracts. However, a bulletin shall not be required if, prior to June 30, 1994, accounting practices and procedures are officially promulgated by the National Association of Insurance Commissioners. The bulletin issued pursuant to this subdivision shall not be superseded by any action of the National Association of Insurance Commissioners that conflicts with or that fails to address matters addressed by the bulletin. No insurer shall engage in hedging transactions with respect to insurance futures contracts or put and call options on insurance futures contracts until the earlier of the date a bulletin is issued or the date accounting practices and procedures are officially promulgated by the National Association of Insurance Commissioners and except pursuant to this section.

*(Repealed and added by Stats. 1993, Ch. 232, Sec. 2. Effective January 1, 1994.)*