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SFA BILL ANALYSIS

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House Bill 5927 (Substitute H-1 as passed by the House)
Sponsor: Representative Andrew Richner
House Committee: Insurance and Financial Services
Senate Committee: Financial Services

Date Completed: 5-23-02

<u>CONTENT</u>

The bill would amend Chapter 9 of the Insurance Code, which regulates insurer investments, to do the following:

-- Increase the amount that an insurer must have in cash or qualified assets (unless that amount is higher than the minimum capital and surplus required).
-- Reduce the amortization schedule of computers that count toward asset requirement.
-- Allow an insurer to count as qualified assets loans, other than surplus notes, to an affiliate authorized to transact insurance in any state or in Canada, and to county surplus notes with the Commissioner's approval.
-- Allow the investment of capital and surplus in any asset allowed for any other person or corporation, if qualified assets were maintained.
-- Permit insurers to invest in United States and foreign government securities without the Commissioner's approval.
-- Allow insurers to count as qualified assets, loans on multifamily residential property secured by an instrument having a maximum term of 35 years, subject to appraised value limitations.
-- Provide that domestic insurers could not invest more than 10% of their surplus in real estate loans that exceeded appraised value limitations, unless the loans were the result of restructuring; and allow the Commissioner to increase the limit to 20%.
-- Regulate insurers' investments in derivative instruments.

<u>Qualified Assets</u>

Under Section 901 of the Code, an insurer may make investments to the same extent as any other person or corporation if the insurer's total assets equal at least the sum of its liabilities including its required reserves, plus either $1 million or an amount equal to the minimum capital and surplus required to be maintained under Sections 408 and 410 of the Code, whichever is less. The bill would increase the $1 million to $7 million.

Currently, for the purpose of meeting the asset requirement, the value of all computers may not exceed 2% of the assets required and the value of each computer may not exceed its original cost amortized over a maximum period of five years. The bill would reduce the maximum amortization period to three years.

Under the Code, subject to certain exceptions, the required assets may not include assets invested in, loaned to, receivable from, secured by, or leased to a person that is owned or controlled by the insurer or that owns, controls, or is affiliated with the insurer. The bill specifies that qualified assets would include loans, other than surplus notes, to an affiliate authorized to transact insurance in any state or in Canada provided that the affiliate had assets in excess of the amount required for the affiliate to make investments. With the approval of the Commissioner of the Office of Financial and Insurance Services, surplus notes could be treated as an investment for the purposes of Section 901.

Currently, amounts loaned to a noninsurance affiliate that is owned solely by the insurer may be included if the loans are rated investment grade by an approved securities rating organization. Under the bill, a noninsurance affiliate would not have to be owned solely by the insurer.

The bill states that, except as otherwise provided, 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 laws of Michigan, as long as the domestic insurer maintained qualified assets as described in Chapter 9 in the amounts specified in Section 901.

Governmental Securities

The Code prescribes conditions under which an insurer may invest it's the bonds or other evidences of indebtedness of governmental entities. With the Commissioner's approval, an insurer also may invest in governmental securities of this or any foreign government, or governmental subdivisions or authorities or instrumentalities not otherwise provided for. The bill would delete the approval requirement. The bill also specifies that a domestic insurer's investment in governmental securities would be subject to prohibition against investing more than 20% of assets in high-risk, high-yield obligations.

Real Estate Investments

Insurers may invest in real estate loans under conditions prescribed in the Code. A loan may not exceed two-thirds of the appraised value of the real estate constituting security, and may not be made for a term longer than five years, except under certain circumstances, including appraised value limitations. The bill also would a loan on multifamily residential property in an amount that could not exceed 85% of the appraised value of the real estate offered as security, if the loan were secured by a mortgage, deed of trust, or other instrument for a maximum term of 35 years. If the total amount of multifamily residential loans in excess of 75% of the appraised value of the real estate were greater than 20% of the insurer's mortgage portfolio, however, the portion exceeding 75% could not be treated as a qualified asset for purposes of Section 901.

Further, a domestic insurer could not invest more than 10% of its surplus in real estate loans that exceeded the appraised value limitations under the Code and the bill, unless the loans were the result of a restructuring of an existing real estate loan and the insurer gave the Commissioner written notice on or before the date of the restructuring. The Commissioner could increase this 10% investment limit to 20% for an insurer that 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 loans under these provisions exceeded 5% of an insurer's assets within any 12-month period, no other such loans could be made without the Commissioner's approval.

The bill also provides that a domestic insurer could not invest more than 20% of its mortgage portfolio in multifamily residential mortgages that exceeded 75% of the appraised value, at the time of the loan, of the real estate offered as security.

Derivative Investments

The bill would repeal provisions in Section 943 that regulate insurers' investments in financial futures contracts, and put options and call options on financial instruments. Under the bill, qualified assets for purposes of Section 901 would include derivative investments under prescribed conditions. An insurer would have to demonstrate to the Commissioner both the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of transactions. Before engaging in a derivative transaction and with board of director approval, a domestic insurer would have to establish written guidelines; have a system for determining whether a derivative investment used in a hedging or replication transaction was effective; have a credit risk management system for over-the-counter derivative transactions; determine whether the insurer had adequate professional personnel, technical expertise, and systems to implement investment practices involving derivatives; and determine that the derivative program was prudent and that the level of risk was appropriate for the insurer.

The bill would define "derivative instrument" as any agreement, option, or instrument, or any series or combinations of an agreement, option, or instrument 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 had 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 any other substantially similar agreements, options, or instruments, or any series or combinations and any further agreements, options, or instruments included under rules promulgated by the Commissioner. Derivative instruments would not include 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 other than under Section 943.

MCL 500.901 et al. Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bill would have no fiscal impact on State or local government.

Fiscal Analyst: Maria Tyszkiewicz

This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.