

CHAPTER 49  
FINANCIAL INSTRUMENTS USED IN HEDGING TRANSACTIONS

Chapter exempt from chapter rescission pursuant to Iowa Code section 17A.7

**191—49.1(511) Purpose.** The purpose of these rules is to set standards for the prudent use of financial instruments used in hedging transactions in accordance with Iowa Code section 511.8(22). This chapter shall be applicable to the legal reserve funds for all domestic insurers and United States branches of alien insurers entered through this state.

**191—49.2(511) Definitions.**

*“Business entity”* means a sole proprietorship, corporation, limited liability company, association, partnership, joint stock company, joint venture, mutual fund, trust, joint tenancy or other similar form of business organization, whether organized for profit or not for profit.

*“Counterparty exposure”* means the amount of credit risk attributable to a derivative instrument entered into with a business entity (“over-the-counter derivative instrument”). No counterparty exposure shall be assigned to transactions involving a qualified exchange or qualified foreign exchange or transactions cleared through a qualified clearinghouse.

1. The amount of credit risk equals:

*a.* The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or

*b.* Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

2. If the over-the-counter derivative instruments are entered into pursuant to a written master agreement which provides for netting of payments owed by the respective parties, and the domicile of the counterparty is either within the United States or, if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

*a.* The market value of the over-the-counter derivative instruments entered into pursuant to the master agreement, the liquidation of which would result in a final cash payment to the insurer; and

*b.* The market value of the over-the-counter derivative instruments entered into pursuant to the master agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

For any open transactions, market value shall be determined at the end of the most recent quarter of the insurer’s fiscal year and shall be reduced by the market value of acceptable collateral held by the insurer or placed in escrow for the benefit of the insurer by one or both parties.

*“Derivative instrument used in a hedging transaction”* means an agreement, option, instrument or a series or combination thereof:

1. 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

2. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

Derivative instruments include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof. Derivative instruments shall additionally include any agreements, options or instruments permitted pursuant to Iowa Code section 511.8(22)“h.” Derivative instruments shall not include an investment authorized by Iowa Code sections 511.8(1) through 511.8(21).

*“Financial instrument used in a hedging transaction”* means a derivative instrument used in a hedging transaction.

“*Qualified clearinghouse*” means a clearinghouse for, and subject to the rules of, a qualified exchange or a 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 exchange*” means:

1. A securities exchange registered as a national securities exchange, or a securities market regulated under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78 et seq.);
2. A board of trade or commodities exchange designated as a contract market by the Commodity Futures Trading Commission or any successor thereof;
3. Private Offerings, Resales and Trading through Automated Linkages (PORTAL);
4. A designated offshore securities market as defined in Securities and Exchange Commission Regulation S, 17 CFR Part 230; or
5. A qualified foreign exchange.

“*Qualified foreign exchange*” means a foreign exchange, board of trade or contract market located outside the United States, its territories or possessions:

1. That has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s regulations, 17 CFR Part 30);
2. That is, or its members are, subject to the jurisdiction of a foreign futures authority that has received regulatory comparability relief pursuant to Commodity Futures Trading Commission Rule 30.10 (as set forth in Appendix C to Part 30 of the CFTC’s regulations, 17 CFR Part 30) as to futures transactions in the jurisdiction where the exchange, board of trade or contract market is located; or
3. 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, but an exchange, board of trade or contract market that qualifies as a “qualified foreign exchange” only under this paragraph shall only be a “qualified foreign exchange” as to foreign stock index futures contracts that are the subject of such no-action relief under this paragraph.

#### **191—49.3(511) Guidelines and internal control procedures.**

**49.3(1)** Before engaging in a derivative transaction pursuant to Iowa Code section 511.8(22), an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:

- a. Address investment or, if applicable, underwriting objectives, risk constraints, and the factors considered in establishing risk constraints such as credit risk limits;
- b. Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and
- c. Require compliance with internal control procedures.

**49.3(2)** An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective. In so doing a company should set specific criteria at the inception of the hedge or hedge program as to what will be considered effective in measuring the hedge and individual hedges in a hedge program and then apply those criteria in the ongoing assessment based on actual hedge results.

**49.3(3)** An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount as provided in rule 49.2(511).

**49.3(4)** The board of directors of the insurer or a committee thereof shall, in accordance with Iowa Code section 511.8(22)“f”:

- a. Approve the guidelines required by subrule 49.3(1) and the systems required by subrules 49.3(2) and 49.3(3); and
- b. Determine whether the insurer has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.

**49.3(5)** For purposes of determining whether internal control procedures are in compliance with this rule, the insurance division may consider, but is not limited to, the following items:

- a. That only the board or its authorized designee can approve derivative instrument transactions;
- b. That the board or its designee exercise administrative oversight of trading functions;
- c. That periodic reporting of open positions to chief investment officer occurs; and

*d.* That periodic assessment of the effectiveness of hedging transactions be conducted by persons designated by the board or its designees.

**191—49.4(511) Documentation requirements.** An insurer shall maintain documentation and records relating to each derivative transaction transacted pursuant to Iowa Code section 511.8(22) including, but not limited to:

1. The purpose or purposes of the transaction;
2. The assets or liabilities to which the transaction relates;
3. The specific derivative instrument used in the transaction;
4. For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount calculated not less than quarterly; and
5. For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

**191—49.5(511) Trading requirements.** Each derivative instrument qualifying for legal reserve purposes under Iowa Code section 511.8(22) shall be:

1. Traded on a qualified exchange;
2. Entered into with, or guaranteed by, a business entity with an investment grade rating by the NAIC Securities and Valuation Office or by a majority of nationally recognized statistical rating organizations (NRSRO), on the NAIC/NRSRO list, that rate the business entity;
3. Issued or written by, or entered into with, the issuer of the underlying interest on which the derivative instrument is based; or
4. Entered into with a qualified foreign exchange.

These rules are intended to implement Iowa Code section 511.8(22).

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