**Section 806.40 Guidelines and Internal Control Procedures**

a) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:

1) Address investment or, if applicable, underwriting objectives, and risk constraints, such as credit risk limits;

2) 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

3) Require compliance with internal control procedures.

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

c) 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.

d) An insurer's board of directors shall, in accordance with Section 126.4 of the Code:

1) Approve the guidelines required by subsection (a) and the systems required by subsections (b) and (c); and

2) Determine whether the insurer has adequate professional personnel, technical expertise and systems to implement investment practices involving derivatives.

e) An insurer may use derivatives for replication transactions as permitted pursuant to Sections 126.18 and 126.31 of the Code. An insurer engaging in replication transactions shall:

1) Comply with the following requirements:

A) The disclosure and annual and quarterly statement reporting of replication transactions;

B) The inclusion of the transaction in the insurer's Risk Based Capital Report (as required by Section 35A-10 of the Code); and

C) If applicable, the calculation and reporting of the asset valuation reserve for the transaction;

2) Comply with the filing requirements for Replication Synthetic Asset Transactions (RSATs) contained in the "Purposes and Procedures Manual of the NAIC Investment Analysis Office", as of December 31, 2022 (National Association of Insurance Commissioners, One New York Plaza, Ste. 4210, New York, NY 10004) (no later editions or amendments), available at https://www.naic.org;

3) File with the Director a duplicate copy of all RSAT filings made with the NAIC Securities Valuation Office. After June 1, 2002, the Director may waive this duplicate filing requirement;

4) Have a system for determining whether a replication transaction has been effective in replicating the intended investment position; and

5) Include all replicated investment positions in calculating compliance with the limitations on investments contained in Article VIII of the Code; provided that no replicated investment position shall be held pursuant to the additional investment authority contained in Sections 126.20 and 126.32 of the Code.

AGENCY NOTE: For purposes of determining whether internal control procedures comply with this Part, the Department may consider, but is not limited to, the following items: that only board authorized individuals can effect derivative instrument transactions; that there is a separation of administrative functions from trading functions; that periodic reporting to a/the chief investment officer of open positions occurs; and that periodic assessing of effectiveness of hedging transaction is conducted by a designated person.

(Source: Amended at 48 Ill. Reg. 7210, effective April 30, 2024)